THE NEED TO EXTEND THE TERRORISM RISK INSURANCE ACT

FIELD HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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WITNESSES

MONDAY, MARCH 5, 2007

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

THE NEED TO EXTEND THE TERRORISM RISK INSURANCE ACT

Monday, March 5, 2007

U.S. House of Representatives,
Subcommittee on Capital Markets,
Insurance, and Government
Sponsored Enterprises,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in the City Council Chambers, New York City Hall, 131 Duane Street, New York, New York, Hon. Gary Ackerman [member of the subcommittee] presiding.

Present: Representatives Ackerman, McCarthy, Velazquez, Bean, Sires, Perlmutter, Murphy; Pryce, King, and Garrett.

Also present: Representatives Maloney, Crowley, Weiner, Israel, and Fossella.

Mr. Ackerman. [presiding] I would like to call the subcommittee to order, and to welcome the members of the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee to New York City. I would also like to thank our many distinguished witnesses, who will be introduced publicly shortly, for taking time out of their busy schedules to appear at our hearing on a very critical topic: "The Need to Extend the Terrorism Risk Insurance Act," also known as TRIA.

I would like to take a moment at the outset to indicate that the chairman of the full committee is Congressman Barney Frank, and that the chairman of this subcommittee is Paul Kanjorski, who is unable to join us this morning due to an unexpected conflict, which brings me to the chair. I am Gary Ackerman, and I represent the Fifth District of New York.

On behalf of the subcommittee, I would like to express our gratitude to Chairman Kanjorski for arranging this important field hearing today, and for his strong support and his stewardship of a fair and comprehensive reauthorization of TRIA.

I would also like to thank the New York City Council and Speaker Christine Quinn for allowing the subcommittee the use of their beautiful chamber this morning, and we are happy to have our landlady with us today, at least for this part of City Hall, the distinguished Madam Speaker, and we are getting used to saying Madam Speaker, with us; and for those of our colleagues who find it sometimes difficult to deal with a bunch of irascible New Yorkers down in Washington, imagine what it is like to deal with a chamber full of them.

So if I can ask and recognize the Speaker, Madam Speaker.

Ms. QUINN. Thank you very much, Chairman Ackerman, and we would like to think we set a trend here in the New York City Council as it relates to Madam Speakers.

Just for the record, when you said beautiful chamber, what you really meant was beautiful chamber in need of a face lift and a clean-up job, and I know that the Mayor agrees with that sentiment in full. He and I will be discussing that later. If anyone trips over anything or feels plaster on their head, please feel free to mention it to the Mayor on the way out. If you visit his side, it is much nicer, but we are working as a team on this matter.

Seriously, I want to very much thank everyone on the subcommittee for being here today, and to thank Chairman Ackerman for holding this hearing here today. We were very, very excited and so happy to open up the chamber to the Congressional subcommittee, because, obviously, the renewal of TRIA is central and critically important to all of us in New York City, and we wish it wasn't so relevant that this hearing happened in Lower Manhattan, but it is, and we were very grateful that all of you saw fit to use our chambers to have this hearing, which I hope sends a clear and strong message about the need to renew this Act in a fair and comprehensive way.

So I want to thank you for reaching out to us, and to say that our chambers are always open to this subcommittee or any other Congressional subcommittee that wishes to use them. We are very excited about all of the opportunities that lie ahead for the Congress and the City of New York to strengthen our connection and deepen the commitment of the Federal Government to New York City.

I know today's hearing, particularly with the witnesses you have today, Mr. Dinallo, our great Mayor, our great senior Senator, will help in that effort of strengthening the connection between Congress and the City of New York, and just urge everyone that we really move as quickly and thoroughly as we can to make sure that TRIA is renewed. It is central to our ability to move forward and fully complete the recovery that we have begun and sought so hard—worked so hard on since September 11th. So thank you all for being here, and again you are welcome to always come back, and thank you for thinking of using the City Council's chambers.

Mr. ACKERMAN. Thank you very much, Madam Speaker. I hope nobody trips in the room. If anybody is concerned, maybe we can find somebody who might be willing to provide some insurance.

New York City is indeed the ideal setting for the hearing of this subcommittee on this topic, New York City being originally the home of the Congress, and it was not unusual for Congress to have meetings and committee meetings here, because that was the only place we had them.

In addition to the enormous loss of human life on September 11th, the value of which cannot be measured, the terrorist attacks on that infamous day caused catastrophic economic losses to this City and to our Nation as a whole. The attacks of 9/11 resulted in $30 billion of insured losses, the largest catastrophic insurance loss in the history of the United States, larger than any tornado, blizzard, or hurricane.

As a result, insurers and reinsurers began to worry about the likelihood and the cost of a future terrorist attack. Worrying about risk and then monetizing that risk is the key to the insurance industry, which itself is an essential element in a modern, dynamic economy. As businesses with legitimate concerns about their solvency, insurance and reinsurance firms started to withdraw from the City of New York's market.

As the supply of terrorism insurance rapidly decreased, New York City developers, who were required to be insured against terrorism, were put in a very precarious position; they needed terrorism insurance to avoid defaulting on their loans, but the market for insurance, quite simply, didn't have enough capacity to meet their demand. Similar shortages began occurring throughout the country. In simple terms, in this case there was a market failure.

It was out of this dilemma and the critical need to address it that the original version of TRIA was born. TRIA increased the availability of terrorism insurance coverage by creating a Federal backstop that would share the burden of losses caused by any future act of terrorism with the insurance industry.

In the wake of 9/11, we had hoped that a temporary, 3-year program would provide enough of a shield to allow the market to fully recover. By late 2005, however, the Financial Services Committee and others in the Congress realized that TRIA had not resulted in as quick or as robust a recovery as was initially hoped. TRIA was extended for an additional 2 years, and is currently set to expire on December 31st of this year.

Failure to extend TRIA would itself be a disaster. It would certainly result in the destabilization of the insurance industry and, in all likelihood, the national economy. Every type of large scale enterprise, and small, would be at risk, and the threat to our national economic health would be immense. Congress has no greater domestic obligation than to ensure the safety of the American people, and this obligation extends to both acts of terrorism and to foreseeable and preventable economic turmoil.

It is my view, and the view of many within the financial services industry, that a long term extension is necessary. It is a cliche, but 9/11 did indeed change everything. The real increased potential for terrorists to commit not just a heinous but a catastrophic act will continue to influence the market's assessment of risk for years.

In the new world in which we live, nuclear, biological, chemical, and radioactive or NBCR coverage must be included in the TRIA program. The Government Accountability Office report in September 2006 found that "any purely market driven expansion of coverage for NBCR is highly unlikely in the foreseeable future."

A study simultaneously undertaken by the President's Working Group came to the same conclusion. Without a significant market expansion for NBCR coverage, the Federal Government must step in and provide coverage.

There is a debate as to how long the reauthorization period should be; whether the trigger, deductible, recoupment, or co-payment levels of existing authorization should be amended; and whether group life insurance provisions should be added to TRIA's framework. I hope that some of the witnesses who appear before

the subcommittee today will address these specific, contentious areas.

There are many different perspectives on these questions and many different interests and equities that are at stake. This subcommittee hearing is just the first step in what will be a long but, I hope, successful journey toward TRIA reauthorization.

We hope to travel down that long road very quickly. Beginning our work here in New York City shows how serious the Financial Services Committee and the Congress are about this vital question to our economy. And now let's get down to business, as we say in New York.

We are going to hear from the ranking member of this subcommittee, the very distinguished Honorable Deborah Pryce.

Ms. PRYCE. Thank you so much. I appreciate the opportunity to be here and the gracious way that New York City has hosted us since we got into town. Thank you all. What a great place to continue this discussion in the new Congress.

After the brutal terrorist attacks of 9/11, America's economy and financial security was certainly at risk. Thousands of innocent people were victimized, and the financial markets were threatened by the largest catastrophic loss in our Nation's history.

Along with the incomprehensible devastation and the loss of life, New York jobs and economic growth were jeopardized by a crippling of the insurance marketplace. The President immediately called on Congress to pass legislation that would prevent economic destabilization caused by a lack of available terrorism insurance, and the House Financial Services Committee sprang into action, produced a bipartisan solution, and established the framework for the current terrorism insurance program.

According to reports by the Treasury Department, the Government Accountability Office, and others, TRIA has been a great success, providing American consumers with the protection against terrorist attacks and continued availability of insurance to protect our economy everywhere.

Since its enactment, the insurance market has become healthier than ever. Insurers have regained lost surplus, diversified risks, and developed increasingly sophisticated terrorism loss modeling. Reinsurance availability for terrorism coverage has also grown, with some recent estimates of $6- to $8 billion available for specific reinsurance, growing by $1- to $2 billion per year.

The private insurance marketplace is also able to manage an increasing level of exposure, and with the right combination of TRIA reforms such as tax reserving and regulatory reform, the terrorism insurance marketplace will continue to strengthen and expand.

I have caucused with my Republican colleagues on the committee, and we are committed to extending TRIA this year. I cosponsored the House TRIA extension bill last year, which included language creating a commission on terrorism risk insurance that was explicitly directed to report back to Congress with specific recommendations for a long term program with the appropriate reforms.

Unfortunately, this commission and several other critical reforms in the House bill were not ultimately adopted, leading members on

both sides of the aisle to comment that we are merely kicking the can down the road.

Some of the specific reforms that were included in the bipartisan bill that passed overwhelmingly in the committee and in the House last Congress included a number of regulatory reforms, such as streamlining of the surplus lines market, a more efficient speed-to-market review of policy forums, more competitive freedom for sophisticated commercial consumers, and encouraged use by all State regulators of a nationwide single point filing approval system to bring better insurance products to consumers.

The bill also removed the tax penalty on long term terrorism reserves to enable insurers to grow dedicated terrorism surplus that would help maintain the stability of the marketplace, if another event occurred.

While the bill increased the responsibility of insurers to manage risk over time with slowly increasing retentions, it also included a reset mechanism to bring the private exposure back down below its current level, if terrorist losses began to accumulate.

The current TRIA program has no reset mechanism and does not aggregate losses from multiple attacks, meaning that we are back to square one if the terrorists return, with insurance pulling out of the marketplace once again.

Perhaps most importantly, our bill last year created a market for nuclear, biological, chemical, and radiological terrorism losses, with a separate silo, granting a more generous Federal backstop. I really think that is important as we consider this bill.

So let's quit kicking the can and get the job done. We need to include appropriate reforms and make appropriate adjustments to the program, make it more dynamic to allow the Federal safety net to contract or expand over time, as the terrorist threat evolves.

Once again, I want to thank my New York colleagues for chairing this hearing and for planning it. There is no more appropriate place than Lower Manhattan to begin this discussion. We will continue to do our part as a committee. This is one of the most important issues facing our Nation. Thank you.

Mr. ACKERMAN. I thank the distinguished ranking member. We will try to conduct as efficient and expeditious a hearing as is possible. We have two great panels, and we have a lot of members present.

After discussions with the ranking member, we are going to limit opening statements of members of the subcommittee. We will try to keep this to 8 minutes on the minority side and 8 minutes on the Democratic side, rather than just go back and forth, because we seem to outnumber you, if not in quality, certainly in quantity. But we will yield you as much time as we have, so that you might divide that among yourselves.

We will ask members on our side, those who wish to make opening statements, to limit them to 1 minute, and encourage anybody who would consider passing on an opening statement to do that in the interest of saving time; and to call the attention to members of the media or the public, there are some members and some witnesses who have their opening statements or remarks in packets that are in the back of the room on your right, our left.

Without objection, all opening statements will be made a part of the record.

Now the first of our two distinguished panels that we will hear from are seated. We will begin with opening statements by members. You may pass, if you like. You are greatly encouraged to do that. I intended to repeat myself.

First, the distinguished gentlewoman from Long Island, Carolyn McCarthy.

Ms. MCCARTHY. Thank you, Mr. Chairman, and I will be very brief. I just want to remind everyone, even though we are having this hearing in New York, and certainly a number of us have been down to where the Twin Towers were, this is a Federal issue; because what we have learned on 9/11, as far as the insurance and, certainly, for the economy, not just for New York, but it is for all of the Nation, and that is why we on the Federal level need to make sure we get this done.

With that, I yield back the balance of my time.

Mr. ACKERMAN. Thank you, very much. We will next go to Representative Nydia Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. I am going to make this very easy; I ask unanimous consent for my entire opening statement to be entered into the record.

Mr. ACKERMAN. Without objection.

The representative from Long Island, Peter King, the former Chair and now ranking member of the Homeland Security Committee of the House and a former member of this committee.

Mr. KING. And a current member.

Mr. ACKERMAN. And you have returned.

Mr. KING. Returned.

Mr. ACKERMAN. We have noticed.

Mr. KING. Being in the minority does wonders for you—for me.

Thank you, Mr. Chairman, and Ranking Member Pryce. It is a privilege to be here today. I am proud to be a member of this committee, because it is addressing such serious issues as terrorism risk insurance and its extension in a bipartisan manner. It is essential that we go forward.

This is really a confluence of homeland security, national security, and economic stability. New York has made extraordinary recovery from September 11th because of the leadership of its officials, including, of course, Mayor Bloomberg, who is here today, but also because of the assistance it did receive from the Federal Government, and it is absolutely essential that assistance be continued with the terrorism risk insurance.

I look forward to the hearing. I look forward, as Congresswoman Pryce said, to getting this resolved so we can resolve this once and for all. With that, I yield back the balance of my time.

Mr. ACKERMAN. Thank you, very much. Next, the distinguished Representative Melissa Bean of Illinois.

Ms. BEAN. Thank you, Mr. Chairman. I will pass on an opening statement. I am just to honored to be here, and I look forward to hearing the testimony. Coming from Illinois, I just want to reiterate that this is important legislation for the entire Nation, not just New York. Thank you.

Mr. ACKERMAN. A recent addition to our delegation from New Jersey, Representative Albio Sires.

Mr. SIRES. Thank you, Mr. Chairman. I will waive my comments, but I would just like to say that this is a regional, as well as a Federal approach. So thank you very much, Mr. Chairman.

Mr. ACKERMAN. Thank you, very much. From Connecticut, new member Chris Murphy.

Mr. MURPHY. Thank you, Mr. Chairman, and thanks to the subcommittee and to the hospitality of the New York delegation for having us all here from Connecticut, only about an hour away. I associate myself with the remarks of Mr. Sires, that this is a national issue, a regional issue and, obviously, an issue of particular importance to the City we sit in today, and I thank the members for being so gracious to allow us to be here.

Mr. ACKERMAN. The distinguished representative from New Jersey, Scott Garrett.

Mr. GARRETT. Thank you, Mr. Chairman, and I thank the ranking member as well. I join Albio as a member from the other side of the river where we live in the shadows of the Twin Towers, and a number of our constituents worked and died and suffered through the tragedies here.

The point that we are discussing today, TRIA obviously was a necessary element at the time, and it has worked. It was not at the time intended to be a permanent fix, but it did stabilize the market. It has been successful, and the President's Working Group, after our re-fix to TRIA, has found that, despite what some people thought at the time, scaling back some of the indicators, as the ranking member indicated, has to continue to work. Insurers have got into the market, and I think our job here is to see what we can do to potentially scale down the market—scale down the program even further, so that there is still a successful program.

Thank you. I yield back.

Mr. ACKERMAN. Thank you. Now the distinguished additional member from New York, someone who has worked long and hard on this issue, Carolyn Maloney.

Ms. MALONEY. Thank you, Mr. Chairman. Some of the members of the committee began our day by touring the site at Ground Zero, and we are making progress, but the engineers made clear that we need at least 15 years of extension in order to get the financing in place to continue the building of the Freedom Tower and all the other aspects, the pools and so forth, at Ground Zero.

I want to thank all of my colleagues for supporting New York during our time of need with $20 billion, but I have to say that an important part of our national security, our homeland security, is our economic security; and there is no more urgent link in our economic security than putting TRIA in place.

We are much better off as a Nation having a plan in place, in case, God forbid, we are attacked again, so that we can quickly respond. Many people come up to me, and they think that TRIA is for insurers, and I want to make clear to the audience, my colleagues and the residents of New York and across this country that the purpose of TRIA is not to protect insurers.

The purpose is to make sure that our economy, our national economy, can respond in an orderly fashion in the event that we have a tragic occurrence.

So I want to thank Chairman Barney Frank, Representative Paul Kanjorski, Ranking Member Pryce, and Representative Gary Ackerman from the committee for coming to New York to see first-hand, to hear from our Mayor, our Governor's representative, the Superintendent of Insurance, Mr. Dinallo, our Senator who fights on this. We thank all of you for being here, and thank you, Mr. Mayor, for hosting us so beautifully last night. Thank you.

Mr. ACKERMAN. The distinguished representative from New York, representing Staten Island and Brooklyn, Vito Fossella.

Mr. FOSSELLA. I have nothing to add.

Mr. ACKERMAN. You have set the record.

All members of the subcommittee having had the opportunity to make opening statements, we will turn now to three other Members of the Congress who—oh, I'm sorry. They put you out of order here. The distinguished gentleman from Colorado, the person coming the longest distance to be with us today, Ed Perlmutter.

Mr. PERLMUTTER. Thanks, and Mr. Chairman, I know you skipped me, because we now have the Democratic National Convention in Denver, and that is why you wanted to overlook me. It is not here in New York. But I do want to say thank you for the hospitality we have been shown on this trip so far.

I have two questions I would like either committee members or the panelists to answer. How much does this cost the Federal Government? If the actuaries can't estimate how much this is going to cost insurance companies, how much are we looking at as a backstop? The second question is: in 2005 why wasn't this extended for a greater period?

So if someone could answer that for me, I would appreciate it. Thank you.

Mr. ACKERMAN. Thank you very much, and I greatly appreciate your adding method to my madness in overlooking you.

Now the members of the subcommittee having had the opportunity and having done that in so expeditious a fashion, we will afford a moment—a minute each to three other Members of Congress who have blessed us with their presence today. First, Joe Crowley, from Queens and the Bronx.

Mr. CROWLEY. Thank you, Mr. Chairman. It's great to be able to—

Mr. ACKERMAN. Former member of the committee.

Mr. CROWLEY. That is right. Thank you. And some have suggested that I have gone to greener pastures. I don't necessarily think that is the case, but I appreciate serving on the Ways and Means Committee.

Senator, good to see you, Commissioner and Mayor. Thank you for participating in the hearing today.

As an original co-sponsor of the TRIA legislation in the House and an original conferee—they never met, although my colleague, Mr. Israel—I think it is incredibly important that we are holding this hearing today and that we are taking this show on the road. I think this is indicative of the new Congress as well. I don't think we would have been here in the last—we weren't here in the last

Congress and, had there not been a change, I don't think we would have been here in this Congress either. So thank you, Mr. Chairman.

Mr. ACKERMAN. Thank you, very much. The distinguished representative of Brooklyn-Queens, with other desires, the distinguished gentleman, our colleague, Anthony Weiner.

Mr. WEINER. Thank you, Mr. Chairman, and I appreciate the committee and the subcommittee meeting here today. You know, the extension of terrorism insurance is not an abstract economic issue. If TRIA is not extended, if terrorism insurance is not extended, banks will cease to provide loans, Ground Zero construction will end, and frankly, what is likely to happen is the single greatest engine for economic growth not only here in New York but around the country, the growth of the real estate community, will grind to a halt.

As uncomfortable as some of us are advocating on behalf of the insurance industry, and mindful as we are that many insurers have acted in a way that has been borderline irresponsible in the way that they have resisted their commitments to rebuild parts of Ground Zero, it is absolutely essential that we not only extend terrorism insurance, but make this not a year-by-year contest on how much fear we can put into the market that Congress won't act.

It is an obligation, I think, on the part of the Nation as part of its responsibilities for accepting a Federal role in the attacks of September 11th, is to permanently extend terrorism insurance, and I appreciate my colleagues being here to make that point.

Mr. ACKERMAN. Thank you, very much. Finally, the distinguished representative from Nassau and Suffolk Counties, a former member of this committee where he worked very hard on this legislation, and abandoned us for the Appropriations Committee, Steve Israel.

Mr. ISRAEL. Thank you, Mr. Chairman. I did have to leave the Financial Services Committee to get on Appropriations. My heart is still very much with this issue and with the committee. My wallet is with the Appropriations Committee, however, and I do very much appreciate your including me in this hearing. I was one of the original sponsors of TRIA in the last Congress and was named to the conference that never met, and I look forward to continuing to work with you and our colleagues on this committee, Mr. Chairman.

Mr. ACKERMAN. Thank you. This committee has now set a record for the period of time in which members made opening statements, and it is greatly appreciated, not just by the Chair but by the audience and the witnesses as well, I am sure.

Now to our first panel. The first witness is the distinguished senior Senator from the State of New York, Charles E. Schumer, most recently a New York Times best selling author of the book, "Positively American." I don't know that copies of the book are in the folders in the back, but if you have one, the Senator will be happy to autograph it before you leave the chamber.

A former member of this committee when he served in the House, Senator Schumer has moved on to bigger and maybe better things, as he currently serves on the Senate Committee on Banking, Housing, and Urban Affairs where he is the chairman of the

Subcommittee on Housing, Transportation, and Community Development, the jurisdiction of which is, appropriately, urban development.

We appreciate the Senator's appearance here with us this morning, and hope he will be able to share both New York's and the Senate Banking Committee's perspective on the need for terrorism risk insurance.

Senator.

STATEMENT OF THE HONORABLE CHARLES E. SCHUMER, A UNITED STATES SENATOR FROM THE STATE OF NEW YORK

Senator SCHUMER. Well, thank you, Mr. Chairman. It is great to be here. It is great to see you running this show with such precision and alacrity. It is a record. I did serve 18 years on the committee. In fact, had I stayed in the House, I would be chairman of the full committee right now, something that I am sure many of my—

Mr. ACKERMAN. We appreciate the fact that you are in the Senate.

Senator SCHUMER. Yes, exactly. I was going to say, something that my colleagues here would have very mixed opinions about, as you just showed, but you really ran it well.

I am also glad to be here in the City Council Chambers, and hope we can avoid any terrorism of the falling plaster that might occur as well. But I thank you all for being here, and I want to thank particularly my colleagues from New York for being here, for demonstrating what an important hearing this is; because let me just say that this issue was a quiet issue, but it is an issue that is extremely important to New York.

It is one of the top three or four issues that will face us in this session of Congress in terms of its effect on New York. It is of critical importance not only to New York, but as Congresswoman Bean brought out, and others, it affects the whole country. It affects any large target, whether it is in New York or outside of New York, and it is really vital to us.

So let's get straight to the point. Congress must act quickly to extend TRIA. It should extend it permanently, and if permanency is not possible, we should extend it for at least 15 years. That is how important this legislation is for us.

We still live in the shadow of 9/11, and it is quite natural for insurance companies, who calculate risk, to look at the worst possible things that could happen and then measure how much insurance they will provide and at what price.

If you think that this is not a danger, as some of my colleagues in Washington sometimes think, look at what just happened with the hurricane. Not only are many insurance companies pulling out of Florida unless they get some kind of permanent Federal backup, but as I am sure Congresswoman McCarthy and Congressman Israel can testify, they are pulling out of Long Island, in the remote eventuality that a Level 3, 4, or 5 hurricane would hit Long Island.

Well, if insurance companies won't write insurance for hurricanes, imagine their view of, God forbid, a terrible terrorist attack which would create much more loss of life, and much more property damage.

So it is almost without doubt that, if we did not have terrorism insurance, one of two things would happen. Either insurance companies would not write insurance here at all in New York and in other large cities, and perhaps for other large enterprises like a Disney World or a Rose Bowl, and construction here in our City and in the country for large projects would come to a grinding halt.

The insurance business is not supposed to be an eleemosynary business. That is how the free enterprise system works, and yet we have to look at the consequences of them looking at their bottom line. Their bottom line would affect our American bottom line, and that is that tens of billions of dollars of projects, hundreds of billions of dollars of economic activity would be gone if we didn't have terrorism insurance.

Maybe one day the fear of terrorism will be gone. That day is not today, and it is not 2 years from now or 5 years from now. Just last week we debated on the Floor of the Senate the ability to scan cargo ships so that, God forbid, a nuclear device wouldn't be placed in one of those ships and exploded in one of our large cities.

If the Congress is debating that issue as a real possibility and debating hundreds of millions of dollars that should be spent on it, how can we say that terrorism is not a worry; and given what we have seen the insurance companies do even when a hurricane occurs, how can we say that they will continue to write insurance here.

Even if they were to write insurance, it would be at such a high price and on such a limited basis that economic activity would slow down dramatically, and millions, not tens of thousands, not hundreds of thousands, but millions of people would suffer.

So I think there is very little doubt that we must extend terrorism insurance. We had trouble extending it in the last few years, because there were ideologues, basically, who said—they didn't look at the facts, and they said we don't want the government doing anything. The very same ideologues, when it comes to some kind of insurance for something in their communities, are often for it. But now we have a new Senate, and I can tell you, Mr. Chairman, in reference to your request, that the Senate Banking Committee is going to look very favorably on a long extension of terrorism insurance, if not permanency, and I know that the House under your leadership, Congressman Kanjorski, Chairman Frank is looking at the same thing. I have talked to all of them about it.

So let me make three points that we ought to be aware of as we do it. First, as I said, the extension should be permanent and, if we can't get permanency, a minimum of 15 years. Why? If you do it a year at a time, every year at this time projects slow down. Someone planning to build something will say, well, there won't be terrorism insurance after December, so I better not build it.

As we see some of our leaders in the real estate industry here in New York, they can tell you, the closer we get to the expiration date, the fewer new projects are planned, the fewer move forward, and to go through this fear pattern every year at great detriment to our economy makes no sense, when at the end of the day we extend it. So let's just bite the bullet and do it once and for all.

Second, we should provide the availability of nuclear, biological, chemical, and radiological coverage. I don't know why one is dif-

ferent than the other. These kinds of catastrophes, which could befall New York or any other large project, large agglomeration of people, will frighten away insurers just like an explosion would or any other kind of terrorism, and to not include them makes no sense whatsoever—makes no sense.

I don't know why we make a division. An insurer doesn't look at how you are killed or how the property is destroyed. They just look at how much, and these are the kinds of things that could frighten insurers away.

Third, we must ensure that there is sufficient insurance capacity for densely developed areas perceived as high risk. Without doing so, we could still be at risk of market disruptions because of a shortage of insurance under the program, and we have missed the whole reason why the program was created.

According to one insurance company, Aon, even with the current TRIA extension in place, there is currently less than $750 million worth of coverage in the entire Lower Manhattan market. This is troubling as we work to rebuild the World Trade Center and the rest of Lower Manhattan. In fact, the lack of this provision in our terrorism insurance law could greatly slow down the redevelopment of Ground Zero and the re-burgeoning as is happening of Lower Manhattan.

Finally, we should move quickly. Fourth, we should not wait until December 1st or December 15th to do this, because there is a December 31st deadline. Let's get it done now. Let's let people go ahead, plan their projects, insure their projects, and then move forward and employ people and build these projects.

So in sum: first, permanency or at least 15 years; second, inclusion of nuclear, biological, chemical, and radiological coverage; third, sufficient capacity for densely developed areas that are high risk; and fourth, let's do it quickly.

Thank you, Mr. Chairman. I very much appreciate the committee coming to New York, which is the number one place affected by the lack or the halting nature of terrorism insurance, and look forward to working with your committee to get something done and get something done right, once and for all, on terrorism insurance.

Mr. ACKERMAN. Thank you, Senator, and thank you for your statement.

We will next turn to the gentleman in the middle of the panel, as he is in the center of everything that is good about New York, Mayor Michael R. Bloomberg.

The 108th Mayor of the City of New York, Mayor Bloomberg brings a unique perspective to our hearing this morning. Aside from his role as Chief Executive of New York City, Mayor Bloomberg's well documented background in the financial services industry makes him a most knowledgeable witness.

In 1982, well before his election as Mayor of the City, Mayor Bloomberg's financial information company, Bloomberg LP, revolutionized the way that Wall Street does business.

The subcommittee very much looks forward to hearing Mayor Bloomberg's extensive expertise in this area, and we are extremely fortunate that he is here with us this morning. We thank him for taking time to appear with us, for hosting us at dinner at the mansion last night, and for setting a national standard for how to get

along without partisanship in governance. Thank you, Mr. Mayor. We are happy to hear from you.

STATEMENT OF THE HONORABLE MICHAEL R. BLOOMBERG, MAYOR OF NEW YORK CITY

Mr. BLOOMBERG. Chairman Ackerman, Ranking Member Pryce, and distinguished members of the committee, good morning. It is my pleasure to be here with Senator Schumer and Superintendent Dinallo, and thank you for inviting me to testify.

Congressman Ackerman, let me first do some housekeeping here. Number one, for the record, the ceiling at this end of City Hall is no worse than the ceiling at the other end of City Hall, and it is functional and safe.

Number two, Senator Schumer's book and my book are both available on Amazon. We are not giving free copies away in the back. At least, I am not giving any free copies of mine away.

Third, your opening statement where you promised an equal amount of time to both parties—I must warn you, it smacks of true bipartisanship, and if I were you, I would be very careful. You will win a lot of points with me on that, but whether from anybody else, I don't know.

Anyway, as Mayor let me also welcome all of you to New York. During your brief visit here, I think you will discover a city that really is facing its future with confidence. If you remember the days after 9/11, there were a lot of people who predicted the worst for New York. They were convinced that businesses were about to flee, our economy would tank and never recover, and crime would once again return to our streets.

Instead, I think it is fair to say exactly the opposite has happened. Over the past 5 years, we have made the safest big city in the Nation even safer, and we have brought our economy back stronger than ever, and certainly stronger than anybody had expected. Last year, unemployment in our city hit an all-time low, and now we are in the midst of one of the biggest construction booms since the end of World War II.

Protecting New York against terrorism has been a critical part of keeping the City strong, safe, and attractive to businesses. The NYPD has built an intelligence and counterterrorism operation that monitors and responds to threats worldwide as they arise, and I think it is fair to say also, they are recognized as models for local law enforcement around the Nation.

We are determined to prevent another attack, and we are sparing no expense. For instance, in this year's executive budget, I have proposed an initial investment of $15 million in the Lower Manhattan Security Initiative, which will help safeguard our bridges, tunnels, and other infrastructure downtown.

But should the worst happen, we must also be fully prepared to minimize the impact on our 8.2 million citizens, as well as on the millions of commuters and tourists who come here every day, principally from outside of New York City and New York State and from the great States of New Jersey and Connecticut.

This preparation includes not only strengthening rescue and recovery operations, but also taking preventive steps to stabilize the City's economy in the event of an attack. The Federal Govern-

ment's leadership in enhancing the availability of commercial insurance has been, and must remain, a crucial part of this strategy.

After 9/11, Congress did a great service to our Nation by quickly passing the Terrorism Risk Insurance Act, or TRIA, which requires insurers to provide coverage against terrorism but caps their total liability, with the Department of Treasury responsible for claims exceeding that ceiling.

This legislation, which was temporarily extended in 2005, is set to expire once again at the end of this year, and with no foreseeable end to the terrorist threats against our Nation, it is imperative that Congress not only renew TRIA but ensures that it is in place indefinitely.

It is up to the Federal Government to continue bearing this responsibility for the simple reason that commercial insurers neither have the ability nor the capacity to provide the full level of desired terrorism coverage.

The numerous factors at play, including the weapons, the methods, the targets and the timing of our enemies, are just far too difficult to predict, and if insurers can't estimate the risk, they simply can't price their product. That means that either they won't sell insurance to many businesses in New York or they will sell it, but only at prohibitively high prices.

Some might say that TRIA is a subsidy to successful developers and insurers, but that is not true. This is about government correcting a serious market failure caused by the threat of terrorism.

Without a doubt, the Federal Government's terrorism insurance program has been a critical part of New York City's revival and is giving businesses the confidence to move forward with exciting new projects. At the Atlantic Yards in downtown Brooklyn, for instance, we are moving ahead on a dynamic commercial and residential development featuring the future home of the Brooklyn Nets, designed by Frank Gehry.

In Long Island City in Queens, we are sowing the seeds of a major new central business district which will complement Midtown and Lower Manhattan. On Manhattan's Far West Side, we are extending the subway line and transforming an old industrial zone into a vibrant new neighborhood, and here in Manhattan, new office towers and cultural centers are rising, as well as almost $10 billion worth of mass transit projects.

In total, these projects and developments will create hundreds of thousands of new jobs and up to 46 million square feet of new commercial space, as well as producing more than $10 billion in additional property tax revenue for New York City each year. Their importance to our economy can't be overstated, but without terrorism risk insurance, none of them would ever get off the ground, and if projects like this are put in jeopardy, so will the future of our City, the global financial leader of America.

The demand for terrorism insurance is clear, and the demand is urgent. Although the current program does not expire until December 31st, the insurance industry writes and renews its commercial properties policies many months in advance, meaning we need to reauthorize this vital legislation now, and I have come here today to pledge to do whatever it takes to get that done.

Before closing, I want to raise two additional issues that must be addressed before the Terrorism Risk Insurance Act is renewed. First, this Federal program needs to eliminate its distinction between international and domestic terrorism.

Currently, TRIA only covers an act of terrorism that is committed on behalf of a foreign person or interest. However, this distinction could be a very difficult one to discern if a domestic group contains at least one member from another country or maintains even minimal contact with other terrorism groups around the world.

For instance, an attack like the one committed by homegrown extremists on London's mass transit system in 2005, if duplicated here, would not be covered by TRIA, and that just makes no sense whatsoever. As long as TRIA excludes acts of domestic terrorism, every business and commercial enterprise continues to be at risk of suffering catastrophic financial losses.

We are in this world together. The world, by Tom Friedman's definition, is flat. There is no unit of any part of government or society that doesn't act internationally in this day and age. We just could not make that distinction between domestic and foreign terrorism.

My second concern is the lack of insurance coverage for what would be some of the most frightening weapons of mass destruction. TRIA currently protects consumers against events involving conventional explosives and the use of airplanes to cause widespread damage, but there is no protection against a potentially more destructive chemical, biological, radiological, or nuclear attack.

By definition, commercial insurance is designed to provide peace of mind, so it is important that any Federal terrorism insurance program is a comprehensive one that addresses all major threats.

We must not only be prepared for yesterday's attacks. The 9/11 Commission has statedthat the failure of preventing 9/11 was a failure of imagination. We need to be prepared for every possible attack, and not just the ones that have already happened.

I appreciate the chance to be with you here today. Hopefully, this hearing will move us closer to ensuring the long-term and affordable solution that our economy needs to continue this growth.

Let me add one other thing. I talk about New York, because I am the Mayor of New York City, but this is an issue for the country. This is an issue for the big cities that are likely to be attacked across this country, whether it is Chicago or Hartford, whether it is L.A. or Atlanta, whether it is Miami or Dallas.

You can go around this country. There are big cities everyplace. Some of them are more at risk from international terrorism because they represent to overseas people what America stands for. They are our symbols. Our skylines matter to them.

Some of them are targets for domestic problems, domestic terrorism, because that is where the domestic terrorists live and may find things that they don't like and that they want to protest against. This is something not just for New York; this is something for America.

Thank you for your time.

Mr. ACKERMAN. Thank you very much, Mr. Mayor.

We will next hear from acting superintendent Eric R. Dinallo, who has been nominated by Governor Elliott Spitzer to be the 39th superintendent of the New York State Insurance Department. Pending the New York State Senate's confirmation, he serves as the Department's acting superintendent.

Acting Superintendent Dinallo has previously served as the general counsel for Willis Group Holdings, the third largest insurance broker in the world, and managing director and global head of regulatory affairs for Morgan Stanley.

We are pleased to have him with us this morning and look forward to hearing his testimony.

STATEMENT OF ERIC R. DINALLO, ACTING SUPERINTENDENT, NEW YORK STATE INSURANCE DEPARTMENT

Mr. DINALLO. Thank you, Chairman Ackerman, Representative Pryce, and members of the committee. Thank you for inviting me to testify here today, and for the opportunity to share some of my thoughts with you on this important topic.

I am the acting superintendent for New York State, and having only been in the office for 5 or 6 weeks, the "acting" is pretty well applied right now. So if I can't answer all of your questions, I apologize, but I can guarantee you that the staff of the Department—which is a fantastic staff, with an incredible depth of knowledge—is there to help you and to answer any of the questions that you may have, if I am unable to do so today.

A lot of the discussion that we have heard so far has made a convincing case that the threat of terrorism is still real, that although it is a threat to the entire country, it is especially an issue here in New York, and that here in New York, TRIA's renewal is essential, but that is also true for the entire country. We need the national, long-term solution of TRIA.

I am here to make two main points and end with some of the specific recommendations that you have asked to hear about. My first point is that TRIA fixes the blind pricing problem. I will explain what I mean by that in a minute, but I think it has been successful, because it fixes what I call the blind pricing problem.

The role of insurance is to permit us to share or pool our risks. The industry has developed very sophisticated models to do this, but they rely on maximal information and data. The problem with terrorism, of course, is that it is very unpredictable and has extreme costs associated with it. Insurers set prices by looking at experience, and predicting future size and frequency, but they lack such information for terrorist attacks.

Normally, insurers use curves of possible losses. The mean or average tells them how much to charge to cover possible losses and still make a fair rate of return. Terrorism has a very, very long tail, in statistical speak, with a small number of events that have huge possible costs. Without the backstop of TRIA, we are asking underwriters to do what is commonly thought to be the most difficult for them; that is, to price blindly.

So the amount they would have to charge to cover all conceivable outcomes becomes prohibitively expensive, and this is across the board in asset management, all forms of underwriting, all forms of insurance. People will tell you that the far end of the curve, which

I hope to show you in a second, is what drives the bell shape and, in fact, has a tremendous impact on the average pricing for all consumers. So it is not just a subsidy for the industry, as some people have affirmed, but it is also something that has a positive impact on a pricing breakdown and fixes what is, I believe, a market failure.

If I could stand up, I could just show you this chart, if that is okay, if I have the permission to stand.

Mr. ACKERMAN. Without objection.

Mr. DINALLO. I don't want to alarm anybody.

I am just going to sketch a quick and simple bell shape curve where you have the number of events on the y axis, and that is zero events, and that is up to potentially infinite events.

Then here you have the dollar value of those events, from zero to some amount, but in general underwriters and asset managers can begin to price this, and the price of insurance is going to be based on the average of having to cover the underside of the bell shaped curve, and the dollars go this way, and the number of events go that way.

Asbestos, for instance—if you changed the time at the bottom, you would have it go out like this. But here is what it appears for terrorism, and I want to show you on this chart how TRIA affects the curve in a very positive way.

Here, you've got the likelihood of the loss on this axis, and you've got the average policy loss under here, and it goes up on the x axis. By engaging a TRIA, you have permitted the underwriters to take away all of this as a pricing problem, and now they don't have to price this in the blind manner that I talked about before.

This, although it is a very small amount visually, is extremely expensive, and the NBCR events that we have heard talked about, some people think, could go as high as three-quarters of a trillion dollars. That is way out here. That dramatically changes the average on this curve.

Current TRIA is set here at $27 billion. The World Trade Center attack, depending on how you calculate it, is $30- $40 billion, and it is appropriately placed in this quadrant, and the storms of 2005 would be $70 billion, about here.

When you put TRIA in place, you bring the mean, the expected average loss without TRIA, from here back to here, because now the underwriters can take this out, and they have certainty in the pricing across here. That results not only in the help to society that we have talked about but in a better rate of return for the underwriters, because they can do it more accurately, but now they can actually offer the insurance at a fair price to the consumers, because the average is brought down to a point that is affordable and can be priced.

My second point is that TRIA is a form of a subsidy, but it does not encourage what is commonly called a moral hazard or a moral hazard conduct or uneconomic behavior.

People do have a healthy skepticism about subsidies, but fear the government assistance will encourage bad behavior, and that is what economists often call a moral hazard. That is not what is going on here.

I think that people living in dense cities, and New York City being the center of the financial services for the world, are good things that ought to be encouraged. TRIA, therefore, is not rewarding or encouraging any kind of a negative behavior, the very issue you would often have with a government subsidy, but it is simply permitting us to properly insure those who are living and engaging in work in a manner we choose to protect and appropriately reward.

Those two points, the blind pricing problem, and that TRIA does not create a moral hazard, lead me to believe that TRIA is not some unacceptable subsidy to the private sector. TRIA permits rational pricing and the fixing of a market failure. TRIA does not replace the private sector. It makes private sector involvement possible.

Okay. In conclusion, I would say that there are five specific recommendations for TRIA; three, we have already covered. We shouldn't be renewing it every 2 years. It is too disruptive to the industry and the CEO's I have talked to and the real estate industry. We need a long-term solution, not a permanent solution.

Obviously, I agree that domestic terrorism should be covered. I don't really see the reason for the disjunction. We should cover NBCR.

The fourth point is that worker's compensation is now covered appropriately by TRIA because of concentration issues in the workplace, and we should continue the workman's compensation coverage, but also with similar logic extend it to group life insurance, where I think the same reasoning applies.

Finally, Congress should consider permitting tax deferred reserves by underwriters, because that is a way to increase the amount industry can handle by itself. Otherwise, underwriters often surplus out dividends or otherwise the amounts that are collected at the end of each year, and I would think that permitting tax deferred reserving would encourage industry to develop a dedicated pool of capital for terrorism exposure.

Thank you, very much.

[The prepared statement of Mr. Dinallo can be found on page 61 of the appendix.]

Mr. ACKERMAN. Thank you, very much.

Unless anybody has a compelling question to ask of anybody on this panel, the Chair would ask that you submit those questions in writing so that we could get to the very distinguished second panel. Does anybody have the need to ask a question of the Mayor or the Commissioner—the Superintendent?

Seeing none, let me thank the distinguished panel for an excellent, comprehensive presentation to us.

The Chair would ask the unanimous consent of the committee to submit for the record at the end of the testimony and the question period statements from the Independent Insurance Agents and Brokers, the National Association of Professional Insurance Agencies, and a paper from the Wharton Risk Center, as well as a paper from the Risk Insurance Management Society, and an article from Swiss Re. Seeing no objection.

Our second panel this morning consists of industry experts as well as individuals representing firms that will be directly affected by the scope and period of extension of TRIA.

We will hear from all of the witnesses, and then we will open it up to questions. Let me call the attention of this panel to the fact that, when you hear the high pitched note, it is not my Uncle Max's hearing aid battery, but the indication that your 5 minutes has expired. Your entire statements, without objection, will be placed in the record, and we ask you to summarize within a 5-minute time frame.

Mr. ACKERMAN. First, we will hear from Dr. Roger W. Ferguson, who is the chair of Swiss Re America Holding Corporation and a former Vice Chairman of the Board of Governors of the Federal Reserve System. Dr. Ferguson is one of the foremost experts in the terrorism risk insurance field, and we are indeed very fortunate to have him with us this morning. We look forward to his testimony and thank him for appearing before the subcommittee at this field hearing.

Dr. Ferguson.

STATEMENT OF ROGER W. FERGUSON, CHAIRMAN, SWISS RE AMERICA HOLDING CORPORATION

Mr. FERGUSON. Thank you very much, and I wish to thank Chairman Kanjorski and also Chairman Frank for holding this hearing on the need to extend the Terrorism Risk Insurance Extension Act, which I think of as a very important and successful public-private partnership.

As you indicated, my name is Roger Ferguson. I had a period of time in public service, and now I am the chairman of Swiss Re America Holding located here in Manhattan as well as Washington, D.C.

TRIA may be analyzed from many different perspectives. As an economist, I would like to share a few thoughts about why this public-private partnership is critical to an important segment of the U.S. economy.

My argument has three parts. First, terrorism does not have the usual characteristics of an insurable risk. Second, industry capacity is insufficient to handle the losses that would arise from a major terrorist event. And third, the government has already created an implicit backstop. From those three points, I conclude it is better public policy to have an explicit Federal backstop for the terrorism insurance market.

Competitive private markets generally lead to the most productive allocation of resources. Nonetheless, markets sometimes fail to function efficiently, creating a waste of resources and a loss of economic value. Terrorism insurance and reinsurance are businesses prone to market failure, because terrorism risk is largely uninsurable for three reasons:

First, terrorism risk cannot be measured satisfactorily, because terrorist events are willful acts undertaken by parties who wish to confound those who study them.

Second, terrorists' coordinated large scale attacks can cause loss occurrences to be correlated over time and across business lines.

Third, and finally, due to adverse selection, terrorism insurance may become unaffordable in the major urban areas where the need for coverage is greatest.

After 9/11 highlighted these dimensions of terrorism risk, its unpredictability, its high correlation of loss occurrence, and the large scale of potential losses, insurers withdrew from the market. In a clear case of market failure, real estate projects, particularly those in target areas such as New York, were delayed or canceled, because insurance could not be secured. This economic domino effect ultimately resulted in the loss of jobs.

Aside from the fact that a terrorist event does not have the usual characteristics of insurability, the potential scale of the risk makes it difficult for the private sector to manage on its own. Although the U.S. property/casualty sector has an aggregate surplus of more than $400 billion and writes nearly $500 billion in annual premiums, it lacks the resources to cover large scale terrorist events. Only a small fraction of industry premiums and surplus is available to cover terrorism losses, because this money must also be available to repay policyholders for losses due to other insured risks such as workers' compensation, product liability, fires, and earthquakes.

Many observers believe that the government would be forced to provide aid to individuals, insurers, and other businesses who suffer devastating losses from a terrorist event, even if they had not purchased insurance. Thus, even without an explicit terrorism risk backstop, the government provides an implicit backstop. Confusion and uncertainty about whether the government would step in is clearly not constructive.

An explicit government terrorism risk backstop offers numerous advantages. First, it reduces ambiguity about pre- and post-event and enhances the transparency by making it clear who will pay how much for what, should an event occur. Second, a broader societal sharing of terrorism risks makes lower premium rates possible. Third, by reducing uncertainty, a backstop reduces the risk of financial market disruption in the wake of an attack.

A viable terrorism insurance market with adequate capacity reduces the level of uncertainty before and after a terrorist attack occurs.

In closing, insurers, Swiss Re among them, generally agree that TRIA has done a good job of stabilizing the terrorism insurance market. There are, however, several elements that undercut the law's benefits.

First is the distinction between certified acts of terrorism, which TRIA covers, and non-certified acts, which it does not. This distinction creates areas of ambiguity.

Second is the law's impermanence. Uncertainty regarding whether the backstop will be renewed every 2 years taxes the energies of lawmakers and insurers.

A final point of note is the exclusion of group life from TRIA's covered lines. Group life business, like worker's compensation, contains a significant concentration of risk. Moreover, group life insurers are not free to manage their risk through terrorism exclusions. Most State regulators do not allow it. A very large scale attack can cause a massive number of mortality claims that threatens the sta-

bility of even the leading group life insurers. In view of this, group life should be part of an effective Federal backstop. Group life insurers have asked that a separate recoupment mechanism be created for group life insurance. This seems to me both logical and reasonable.

To help meet the threat of terrorism—that the threat of terrorism poses in a proactive, economically efficient manner, we ask this subcommittee to craft a permanent public-private response that builds on the strengths of the insurance industry and also the obvious strengths of the government.

Thank you for the opportunity to express our views on this very important matter.

[The prepared statement of Mr. Ferguson can be found on page 76 of the appendix.]

Mr. ACKERMAN. Thank you very much, Dr. Ferguson.

Next we will hear from John L. Lieber, who is the senior vice president at Silverstein Properties where his primary responsibility is oversight of the rebuilding of the World Trade Center. We also note that Mr. Silverstein himself has joined us here today. We appreciate that.

Mr. Lieber is also testifying this morning on behalf of the Real Estate Board of New York, and we look forward to his testimony now.

STATEMENT OF JOHN N. LIEBER, SENIOR VICE PRESIDENT, WORLD TRADE CENTER PROPERTIES, LLC

Mr. LIEBER. Thank you, Chairman Ackerman, Ranking Member Pryce, and distinguished members. As Congressman Ackerman said, I am here representing not only the Silverstein organization but also the Real Estate Board of New York, which is the premier trade organization of owners and developers in this great City, and you will hear from one of our leading members, Mr. Green, in his capacity as a leader of CIAT in a moment.

As you know, Larry Silverstein leased the commercial office portion of the World Trade Center just 6 weeks before 9/11, and since then, and after many years of debate and public dialogue, which has been very productive, all parties, the State and City of New York, the State of New Jersey, and the Port Authority have come together on a plan and are fully united on what will be rebuilt at the World Trade Center when, where, and by whom.

That means that the whole site is going to be rebuilt by 2012, and you saw the beginnings of that work when you visited the World Trade Center site today.

Over the past few years since the enactment of TRIA, the private insurance market has rebounded, to a degree. However, in some areas—and I have to emphasize this point—especially densely developed areas perceived as high risk, like Lower Manhattan, there is, even with TRIA in place, simply insufficient insurance capacity, both terrorism insurance and other insurances that have a terrorism component, such as builder's risk insurance.

This is the situation that we are facing in Lower Manhattan and also, to a degree, in Midtown as well, and those two business districts comprise 450 million square feet of office space.

As other speakers have said, the most important action that Congress can take to assure the availability of terrorism insurance for areas like New York City is to extend TRIA permanently. A long term program is just necessitated by the realities of how buildings are developed, financed, and insured. Lenders are looking at timelines well beyond a 2-year type extension. They need to know that the insurance is going to be there for the full life of the loan, and that is really a major factor that we have to deal with, and permanency would address them.

There is another point that I think I have to emphasize which is slightly different than what you may have heard from others, the need for additional capacity to areas like New York City, these densely developed areas. All over the City, real estate owners and developers are struggling to obtain and maintain sufficient terrorism insurance.

I spoke to a major owner of Lower Manhattan—a Lower Manhattan portfolio worth approximately $10 billion who has such trouble obtaining insurance that they have only a billion dollars of coverage. Another owner can only get $1 billion of insurance, of terrorism insurance, which is less than a third of the total value of their several buildings in the Rockefeller Center area; and our project, the World Trade Center rebuilding, really brings this problem into relief.

The total cost of the project, as you may have been told, is roughly $13- to $15 billion, but as Senator Schumer pointed out, according to leading insurance brokers, there is only $750 million of capacity, of terrorism insurance capacity, available in Lower Manhattan. So there is a very serious disconnect.

We strongly believe that a TRIA extension ought to address the capacity problem of densely developed urban areas branded as high risk, for example, Lower Manhattan, Times Square, and the Grand Central, and so on.

Today you heard from Senator Schumer, Mayor Bloomberg, Superintendent Dinallo, and others about a variety of different fixes that we all believe in, the NBCR issue, eliminating the foreign versus domestic distinction. Those are all urgently needed to increase capacity. But I should emphasize that, even if these important corrections are made, there will still be questions about whether there will be sufficient capacity in high risk areas.

So we suggest that you give consideration, not wedded to any particular mechanism, that consideration ought to be given to some actions to alter the risk-reward equation so that insurers will be incentivized to come into these types of areas.

There is one other step that Congress can take in the TRIA extension in order to free up terrorism insurance capacity. We urge that the TRIA extension clarify the scope of coverage by making it clear that the TRIA backstop supports all consequences of a terrorist attack, including a fire or a collapse following an attack, as well as the damages from the initial impact or explosion.

Unfortunately, the scope of TRIA coverage is currently perceived as somewhat unclear and, therefore, terrorism risk, as perceived by the insurers, is bleeding into builder's risk and property insurances and causing a shortage of capacity for those insurances, again especially in areas like Lower Manhattan.

Finally in conclusion, the TRIA program is essential to give us any chance of obtaining the terrorism insurance which lenders and investors require. It has been a success and should be made permanent. However, we do need absolutely to deal with the issue of capacity for downtown.

It would be a great disappointment to everyone here and everyone involved with the TRIA program if the redevelopment of the World Trade Center were seriously hindered by an inability to obtain terrorism insurance, and we need the leadership and creativity of this community—this committee and this community to assure that a new TRIA bill addresses that particular issue.

Thank you.

[The prepared statement of Mr. Lieber can be found on page 126 of the appendix.]

Mr. ACKERMAN. Thank you very much, Mr. Lieber.

Steven L. Green is the chairman of the Board of Directors and the chief executive officer of SL Green Realty Corp., the largest commercial office landlord in the City of New York. SL Green owns approximately 24.5 million square feet of office space in New York City.

The committee looks forward to hearing Mr. Green's testimony about the impact that TRIA reauthorization and how that authorization is packaged will have on commercial properties in New York and other large cities.

STATEMENT OF STEPHEN L. GREEN, CHIEF EXECUTIVE OFFICER, SL GREEN REALTY CORPORATION, ON BEHALF OF THE COALITION TO INSURE AGAINST TERRORISM

Mr. GREEN. Good morning. Thank you, Chairman Ackerman, Ranking Member Pryce, and members of the subcommittee for holding this hearing in New York City and for allowing me to testify today.

My name is Stephen Green, and my background you have gone over. So there is no point in repeating it, but I am also here as vice chairman of the Real Estate Board of New York. I am testifying today on behalf of the Coalition to Insure Against Terrorism, CIAT as it is referred to, which represents a broad range of businesses and organizations from across the United States, business that are the Nation's principal consumers of commercial property and probably casualty insurance.

Sometimes the subject of today's hearing is characterized as an insurance industry issue. I respectfully suggest that it is not. It is really an issue of national economic security. It is an issue of jobs, and it is an issue of protecting the investment of pensioners, shareholders, bond holders, and individuals from across the Nation, protecting them from the potential economic devastation caused by a foreign enemy dedicated to the destructions of our economy, our property, and our institutions.

As everybody has come here and stated, I also believe that it is a responsibility of the Federal Government to protect both its citizens and their property from foreign enemies. There is certainly strong precedent for this in the form of the War Insurance Corporation which was established by Congress some 6 days after Pearl Harbor.

The War Insurance Corporation provided property owners in the United States with insurance protection against loss or damage resulting from enemy attack. Both fixed and movable property was insured.

Since 9/11, this committee and our Congress, Republican or Democrat, we recognize, have worked hard to find solutions to the economic risks associated with terrorism. The terrorism insurance law you enacted certainly has been very welcome. I should say it is vital to our industry, but the current law, TRIA, set to expire in just 7 months, is creating an uncertainty in the market, and I assure you from my own experience that until either that law is extended or a permanent law is voted on, the insurance companies are not eager to provide us the insurance on a certain—with a level of certainty.

Holding this hearing today in the shadow of Ground Zero recognizes the fact that—the essential facts that you understand what happened in 2002, and you want to continue the TRIA, the concept of TRIA. Terrorism continues to be an unpredictable threat today here in New York with obvious mammoth losses. Insurers continue to say terrorism risk is uninsurable due to lack of underwriting criteria and history.

Our economy continues to need terrorism insurance in order to function, and our economy needs the mechanism the program provides to enable us to recover quickly and efficiently after a terrorist attack. I support market solutions to problems where possible, but the market in this case has failed due to lack of capacity and ample consideration, and it shows no sign of reviving itself.

We need Congress to act as soon as possible, but we urge you to not simply extend the current law for a few years. We think that whatever is done must be put in place for many years to come. It should be made permanent. Obviously, what has gone on in the past 3 or 4 years, it seems quite evident that terrorism will be here for years to come, and our need for TRIA will be here for years to come.

In addition, we respectfully suggest that the current terrorism insurance laws need to be modernized in a number of ways. While TRIA has been largely successful, there are huge and significant availability problems. For example, there are major markets today, particularly in high urban areas with fire-following laws, such as New York, where the combination of aggregation of risk, high retention rates for the insurers, and rating agency pressure on insurance companies are causing significant capacity problem for conventional terrorism coverage.

In other words, some markets today, businesses, still cannot buy levels of terrorism insurance that are mandated by their mortgages. Moreover, the government today and the Government Accountability Office has identified weapons of mass destruction, what is known as NBCR. It is not available in the market today, notwithstanding the fact that TRIA backstops such insurance.

Did I hear that buzzer? Okay, then I was told to say: In summation. In summation, firstly, I can't read the rest of my remarks in summary. Most of it, you have heard.

NBCR is vital, because the $100 billion cap that you have put on it today is not adequate, and insurance companies don't feel it

is adequate, and we cannot get NBCR. I would respectfully urge this committee to take that and make that as part of—create legislation that will require that kind of insurance like normal terrorism insurance.

I thank you, and I look forward to your questions.

[The prepared statement of Mr. Green can be found on page 96 of the appendix.]

Mr. ACKERMAN. Thank you very much, Mr. Green. Let me assure you that your entire written testimony as presented will be in our record and will be read by everybody as well.

Warren Heck is the president and chief executive officer of Greater New York Mutual Insurance Company, a leading provider of commercial, multi-peril, and worker's compensation products in the northeast and Mid-Atlantic States. We are glad to have you and look forward to hearing from you.

STATEMENT OF WARREN HECK, CHAIRMAN AND CEO, GREATER NEW YORK MUTUAL INSURANCE COMPANY, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. HECK. Thank you, Chairman Ackerman, Ranking Member Pryce, and members of the subcommittee. As you indicated, I am chairman and chief executive officer of Greater New York Mutual Insurance Company, a medium-sized insurer which is the fourth largest writer of commercial multi-peril insurance in New York State and one of the largest writers of commercial multi-peril insurance in New York City.

While I am here today to discuss the experience of my own company, my perspective has also been shaped by my service as the chairman of NAMIC's TRIA Task Force. I have no doubt that TRIA and TRIEA played a major role in preventing an economic catastrophe in helping to get New York City and the country back on its feet economically after 9/11.

I am deeply concerned that, if Congress does not adopt a long-term, private-public terrorism risk insurance program, many of our citizens who need terrorism coverage to operate their businesses across our Nation will either be unable to get insurance or unable to afford the coverage that is available.

The experience in New York City following the 9/11 tragedy demonstrates why Congress must extend TRIEA. Immediately after the terrorist attack, most primary insurance carriers began to non-renew their large commercial property and worker's compensation business or reduce their limits of coverage to levels below what was needed by the business community. The result was very harmful to the New York economy, leading to the postponement of many construction projects and significant increases in pricing of commercial multi-peril insurance.

The few remaining insurers increased their prices because of the significant terrorism exposure, and many cut back when concentrations of values and employees became too large. TRIA reduced the fear that a worst case terrorist event could render my company insolvent. Without the passage of TRIA and TRIEA, our company could not have provided adequate levels of coverage for many of the

existing policyholders in New York City and retained the insurance capacity needed to write new business.

5½ years after 9/11, with no other terrorist attack on U.S. soil, terrorism reinsurance availability remains limited, and the prices are extremely high. Without the government backstop, I believe the primary insurance market would have dried up in large urban centers, particularly in New York City.

These and other problems flow from a simple and inescapable fact, and you heard it from other witnesses, that terrorism is a classic uninsurable risk. In order for the private market to function efficiently, it needs the availability, and I won't go into that anymore. I think you have heard it enough.

Though terrorism modeling can help individual insurers reduce their exposure by quantifying their risk, it cannot protect an entire industry and the economy against damages that could run into hundreds of billions of dollars. Only the Federal Government can do that.

My experience tells me that without a Federal program, we would again find ourselves in the immediate post-9/11 situation, with insurers excluding terrorism unless required to offer it by the States. Insurers forced to write such coverage would have no choice but to either charge very high rates or decline to write the business, thereby inhibiting economic growth.

Further, there is no evidence or reason to believe that the capital markets will replace the missing insurance capacity or that TRIEA has crowded out private market capacity. The capital markets take their cue from the reinsurance markets.

Key players have indicated that the potential market for terrorism bonds is $1- to $2 billion at best over the next 5 years, and there is no appetite whatsoever for developing a bond market for NBCR events.

Since the Federal Government has historically assumed the large responsibility for large natural catastrophes, it seems fair to conclude that the government would step in and help people harmed by a future terrorist event. Thus, the importance of a long-term, private-public terrorism insurance plan to the Federal Government is that it would reduce its exposure and provide for an orderly processing of claims.

The insurance industry has been working to devise such a long-term program for Congressional consideration that would maximize private sector participation without threatening the economic viability of the industry.

A critical consideration for my company and small and medium sized insurers that NAMIC represents is the event trigger. Too high a trigger would drive them from the market, because reinsurance costs would be too expensive, making primary coverage unaffordable. I think a $50 million trigger would be likely to assure the continued involvement of these insurers in the state of terrorism insurance.

It is important to recognize that these insurers provide competition for larger insurers, and thereby lowering prices for policyholders, and really creating a competitive market.

NAMIC also supports the creation of a federally chartered entity that would establish a reinsurance market to help companies man-

age their risks retained. With voluntary insurer participation, this middle layer of potential risk bearing capacity would provide the kind of private market test that some in Congress believe is needed.

Finally, NAMIC supports a long-term program of at least 5 years, and more than that would be very helpful to prevent the destruction in the market that took place as TRIA was about to expire in 2005.

My written testimony contains a more detailed description of NAMIC's views regarding a long-term program. I want to thank you once again for the opportunity to testify on this issue of vital importance. NAMIC appreciates your continuing leadership, and we stand ready to assist you in any way possible in developing an effective long-term terrorism insurance plan.

Mr. ACKERMAN. Thank you very much, Mr. Heck, and I assure you as well as the other members of the panel that your full statements have already been distributed to all the members of the panel and will be carefully read.

[The prepared statement of Mr. Heck can be found on page 105 of the appendix.]

Mr. ACKERMAN. Steven K. Graves is managing director and chief operating officer for Principal Real Estate Investors. Mr. Graves directs mortgage originations and mortgage servicing portfolios that include investment activities in more than 60 markets nationwide. While TRIA certainly had a significant impact on the City of New York's market, we are looking forward to hearing from Mr. Graves about the impact that TRIA has also had on other markets as well.

Mr. Graves.

STATEMENT OF STEVEN K. GRAVES, CHIEF OPERATING OFFICER, PRINCIPAL REAL ESTATE INVESTORS, ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION

Mr. GRAVES. Thank you, Chairman Ackerman, Ranking Member Pryce, and distinguished committee members, for inviting me here to speak this morning.

My company, Principal Real Estate Investors, is one of the Nation's largest commercial real estate lenders with $22 billion in mortgages under management and administration. Consequently, we are a major stakeholder in the future of the Terrorism Risk Insurance Extension Act. In fact, because of TRIEA, terrorism insurance is in place for over 90 percent of the commercial real estate mortgages that my company administers. However, with the expiration of TRIEA looming at the end of this year, Congress must take action to implement a long-term solution.

TRIA and its subsequent extension has been an unqualified success for increasing the availability and affordability of terrorism insurance. This is true not only for high valued trophy properties located in high profile markets, but for the entire commercial real estate market.

In fact, an MBA study revealed that 84 percent of all commercial real estate projects included in the study had terrorism coverage in place. In addition, the study revealed that the average property value for properties with coverage was just over $5 million. This is a far cry from what most would consider a trophy property.

The chief factor behind the success of TRIEA is the "make available" provision which requires insurers to offer coverage in order to participate in the Federal terrorism reinsurance program. In fact, most currently available policies are directly conditioned to the TRIEA "make available" provision.

Thus, if the "make available" provision was excluded from a long-term or permanent terrorism solution, a wide range of borrowers and commercial real estate loan servicers would be caught between their contractual obligations to have terrorism insurance in place and a lack of available terrorism insurance. Accordingly, MBA strongly encouraged Congress to include a "make available" provision in any TRIEA extension bill you consider.

With over $2.8 trillion in debt outstanding, the commercial multi-family real estate debt sector is an integral and large part of the Nation's economy. This debt finances the vast majority of office, retail, industrial, and multi-family buildings. These buildings house the businesses that are the engines for the Nation's economy.

A lack of available and affordable terrorism insurance would not only impact the commercial real estate finance sector, but would ripple through the economy as buildings become more difficult and costly to finance and purchase. Available and affordable terrorism insurance is not only necessary for commercial real estate finance sector. It must also be an important part of our Nation's response to the threat of terrorism.

Typical commercial mortgages are highly leveraged. In addition, most commercial real estate lending is non-recourse, which means that in the case of default, the lender can only look to the underlying value of the property to recover its mortgage balance. As a result, lenders have an acute interest in preserving and protecting asset values.

In order to protect their interest, lenders place paramount importance on requiring and verifying that uninterrupted insurance coverage, including terrorism insurance, is in place for the life of the loan.

For these and other reasons, commercial real estate lenders mandate terrorism insurance be in place as a condition for funding a loan. Should terrorism insurance become unavailable, lenders would face a decision of violating their underwriting requirements, would no longer fund loans.

A large scale cancellation of new construction projects and funding of new loans in the aftermath of September 11th strongly indicate that lenders would dramatically curtail their activity.

MBA believes the Federal Government must act to achieve a long-term terrorist risk solution. An extension should include the following elements.

Terrorism insurance needs to be widely available, requiring an extension of the "make available" provision in the current law. The bill should eliminate short term interruptions in terrorism insurance availability and price shocks when it is implemented. This will require at least a decade-long extension of the program.

Terrorism insurance needs to be priced in an affordable manner and cover all perils, including nuclear, biological, chemical, and radiological threats from both foreign and domestic sources.

Any long-term solution needs to preserve and implement the required notifications to loss payees and additional insurance of coverage lapses, gaps, and renewals.

Once again, I appreciate the opportunity to provide our perspective on terrorism insurance to the subcommittee. As the Nation's largest representative of commercial real estate mortgage lenders and servicers, the MBA stands ready to provide any assistance that you may require.

We look forward to partnering with you, government agencies, and the insurance industry to help craft a long-term solution for terrorism insurance that makes terrorism insurance coverage inclusive, available, and affordable.

Thank you very much for your attention in this vital matter.

[The prepared statement of Mr. Graves can be found on page 79 of the appendix.]

Mr. ACKERMAN. Thank you very much, Mr. Graves.

Donald K. Bailey is the chief executive officer of Willis North America, one of the largest risk management firms in the United States. Mr. Bailey is responsible for managing the company's strategic direction throughout the United States and Canada. We appreciate his appearing before our committee this morning and look forward to hearing his perspective on terrorism risk insurance and the impact of TRIA.

Mr. Bailey.

STATEMENT OF DONALD J. BAILEY, CHIEF EXECUTIVE OFFICER, WILLIS NA

Mr. BAILEY. Good morning, Chairman Ackerman, and Ranking Member Pryce. My name is Don Bailey, and I am the CEO of Willis North America, a unit of The Willis Group, the global insurance broker. It is a distinct pleasure and honor for me to join you this morning.

Willis works with corporations, public entities, and institutions around the world on all matters of commercial insurance, reinsurance, risk management, financial, and human resource consulting.

In addition to representing Willis here today, I am also speaking this morning on behalf of the Council of Insurance Agents and Brokers. The Council represents the Nation's leading commercial property and casualty insurance agencies and brokerage firms.

With our Willis North American headquarters located not far from where we are gathering this morning, we experienced first-hand the devastation wrought on New York City by the events of September 11, 2001. Since that time, we in the United States have been fortunate that we have not experienced another terrorist attack on our soil. However, if you look to London, Madrid, and other locations around the world, I think we can all agree that terrorism is a permanent problem for which we need a permanent or at least a sustainable solution.

Regrettably, the question of another terrorist attack here in the United States is a matter of "when" and not "if." We thank the committee for convening this hearing to explore the long-term solutions to terrorism risk insurance.

Prior to September 11th, terrorism insurance was readily available. It was offered as an add-on to many policies at very modest

prices, because the threat was perceived to be very low. Clearly, after September 11th, that paradigm shifted quite significantly. Terrorism insurance was almost entirely unavailable, and the small amount that was available was prohibitively expensive. Planes didn't take off. Many construction sites in what we now perceive to be high risk zones, including those here in New York City, fell silent, and commerce in many cities came to a halt.

Congress, realizing the dire need, acted quickly by passing TRIA and subsequently the extension to provide available and affordable terrorism capacity for U.S-based risks. The program has also allowed the private market to progressively increase its role in covering terrorism risks.

The Federal funds provided by TRIA backstop have never been tapped. Not one taxpayer dollar has been spent on claims, but the program has been an unqualified success in stabilizing the insurance markets and allowing insurers to provide much needed terrorism coverage at affordable prices. Policyholders, the business of our economy, have not had to deal with extremely high and volatile terrorism insurance costs, and have been able to budget for their business plans. For many commercial policyholders, obtaining terrorism coverage means more than just peace of mind.

It is essential to doing business. It may be required sometimes by State laws and regulations and often by contract, to obtain a mortgage, for financing of new construction, for the expansion of a business, or for a new entrepreneurial venture. Think of the impact none of those activities happening would have on the business of New York.

Some suggest that the private market can handle the losses. Consider this: Estimates indicate that there is only about $6- $8 billion in global terrorism reinsurance capacity available, but terrorism losses from a single attack could reach $100 billion.

Industry numbers indicate that there is $1- to $2 billion in capacity available for nuclear, biological, chemical, and radiological coverage, yet the American Academy of Actuaries modeled the impact of a medium sized nuclear, biological, chemical, or radiological attack in New York City at in excess of $450 billion.

Clearly, there is simply not enough capacity in the private market to cover losses due to terrorism, and the limits of such an attack, potentially exponentially beyond what we saw at the World Trade Center, are bound only by the imagination of terrorists and thought processes that are beyond the scope of models and calculations.

Some contend that dealing with the risks of terrorism insurance is a matter for the industry to handle on its own: Collect the premiums; assume risk of a potential loss, as they do with other categories of risk. But consider that a terrorist attack is not perpetrated against a company or a building. The terrorists who flew planes into the World Trade Center and the Pentagon and the plane that crashed into the field in Pennsylvania—they were attacking our country. Could you imagine a scenario where the Federal Government knew an attack was going to happen and did not take steps either to prevent it or at least prepare for the aftermath? I suggest that not developing a long-term terrorism risk insurance program would be just that.

The objectives of TRIA are clear: Harness private industry capacity to directly contribute to terrorism related losses; deliver Federal assistance in a fair and efficient manner; and repay the government for any outlays. Because of TRIA, the terrorism insurance market has largely stabilized. Terrorism coverage has been steadily expanding, and the price of coverage has become more affordable. Now is decidedly not the time for the Federal Government to withdraw its involvement in the terrorism insurance market.

Terrorism threats facing our country remain significant and unpredictable. Our reinsurance industry still lacks sufficient capacity to address terrorism risks on its own, and the primary insurers are still not willing to expose themselves to enormous terrorism risks without charging prohibitively high prices.

Allowing TRIA to expire at this time will certainly cripple, if not completely paralyze, a significant portion of our economy. TRIA is not about protecting the balance sheets of insurers and brokers. It is about protecting commercial policyholders and creating and sustaining a national economy that encourages investment and development.

This is a matter that far transcends the insurance industry. It is a matter of our national economic security, and I thank the committee for your time this morning.

[The prepared statement of Mr. Bailey can be found on page 48 of the appendix.]

Mr. ACKERMAN. Thank you very much, Mr. Bailey.

Our final witness, Edmund F. Kelly, is chairman, president, and chief executive officer of Liberty Mutual Group, the sixth largest property and casualty insurer in the United States. So terrorism risk insurance is, obviously, a very important issue for Liberty Mutual Group, and we look forward to hearing Mr. Kelly's perspective this morning.

STATEMENT OF EDMUND F. KELLY, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, LIBERTY MUTUAL GROUP

Mr. KELLY. Thank you, Chairman Ackerman, Ranking Member Pryce, and distinguished members of the committee. I also thank you for the opportunity to testify on what we view as one of the great challenges facing our Nation, the economy, our policyholders, and industry.

As many of the members remarked, it is fitting that we meet here in New York, which bore the brunt of the cost of terrorism. We at Liberty Mutual are proud to insure such well known New York institutions as Macy's, Morgan Stanley, New York University, and J.P. Morgan, Chase, as well as our role in insuring the private contractors who cleaned up the World Trade Center after the event.

The economic security of this City is of great importance to us and the Nation, and I commend the chairman and ranking member for their commitment to extend TRIA, and look forward to working toward that end.

The economic consequences of terrorism present a very difficult long-term challenge. In particular, it is important that we are assured the financial resources are available quickly to rebuild the lives and businesses that will be damaged by an act of terrorism.

It is with great pride that we can look back—we in the insurance industry look back—at the events following 9/11 as we quickly, fairly, and sensitively met our legitimate obligation and paid every single legitimate claim quickly. We are proud of that record, and I stand here to reaffirm our commitment to do it again.

Unfortunately, the possible scope of a terrorism act is too great for us to withstand. We need more permanence. The ranking member echoed former Chairman Mike Oxley in saying we can no longer kick the can down the road. We have been doing that now for too many years.

Fundamentally, I would agree with the other panelists that the public-private partnership represented by TRIA is sound and has worked remarkably well. Look at the effect of the industry deductible. It is far from a gift to insurers. Under the current Act, our deductible, Liberty's retention would be close to $2 billion before TRIA would kick into help us—$2 billion, hardly a handout to the industry. But because of those deductibles, we and our competitors have worked with the policyholders to increase the security and safety of their buildings and their employees.

It is that role that we in the private sector can play so well. We understand risk, and we understand how to work with our policyholders to reduce that risk, so maintaining that deductible is critically important.

Also the deductible allows some development of private market capacity to meet the terrorism risk. I say some development, because there is not enough private capital in the world to meet a large terrorism event. It is easy, very easy, to construct an event that would cost up to three-quarters of a trillion dollars, and yet as mentioned earlier, the entire P&C industry has only roughly $150 billion in capital to address the TRIA risks.

So we do need an extension. However, there are several things we could improve on. People have all mentioned before permanency, the elimination of the distinction between foreign and domestic terrorism, and of course, increasing the overall cap from $100 billion, which would be meaningless in the case of a significant event.

Others have mentioned the recovery surcharges. I urge you to think long and hard before assessing post-event premium surcharges. Those surcharges will not be borne by large businesses. Surcharges, mandatory charges, inevitably become a burden for small and medium sized businesses, as large and wealthy businesses increase their self-insured retention and reduce their premium, so it would be a tax on mid-size and small businesses.

Second, we at Liberty Mutual are very encouraged by the discussion of tax deductible reserves. However, our public counterparts may have a problem with the gap accounting for such reserves. So there are technical issues to look at. However, we think it is a very good idea, well worth exploring.

So in summary, we need TRIA. We need a permanent TRIA. The current structure worked basically very well. With a little bit of tweaking, it can work very well for the long run, and we at Liberty Mutual and the rest of the industry look forward to working with you as we address this significant issue.

[The prepared statement of Mr. Kelly can be found on page 116 of the appendix.]

Mr. ACKERMAN. Thank you very much, Mr. Kelly.

The Chair notes that, despite the seemingly unwieldy size of the witness table and the power therein represented, that you are probably one of the most disciplined panels that I have ever seen, keeping within the time constraints that we indicated. We appreciate that.

The Chair, with the consent of the members, unless there is any objection, will limit to 3 minutes the questions of each member, and see where that takes us. I think, that way, we could possibly get out—that is for the question and answer—so that we can get out on time.

I think most people at the panel referred to either permanency or long term. Nobody is advocating for mid-term or short term extensions, at least on this pretty diverse panel. Yet there is some controversy in the Congress as to the length of time of the extension, going anywhere from 3 years to a mid-range of 6 to 8 years, to 10 years, to 15 years and permanent.

Anybody want to advocate other than—well, let's just pick a number? What would be the barest minimum that you think would make any real sense for planning and other purposes? Maybe just a quick answer from each of the—anybody who would want. Let me put out that way. Mr. Green?

Mr. GREEN. 10 years.

Mr. ACKERMAN. 10-year minimum?

Mr. GREEN. Yes, or until the threat is depleted, whichever occurs first.

Mr. ACKERMAN. I know how to measure 10 years. Anybody else want to?

Mr. GRAVES. The Mortgage Bankers Association favors a permanent solution, but 10 years, we would view, as a minimum.

Mr. HECK. I would suggest—I said a minimum of 5 years, but I do think that 10 years is a better minimum, and the reason is that in the last year when the TRIA or the government backstop is running out, insurance companies have a dilemma, and they never know whether it will be extended, and they begin to non-renew business, and it really is very disruptive of the economy. So I think the longer, the better, and of course, 10 years is a minimum, and my hope is that it will be indefinite.

Mr. KELLY. I believe in starting a football game inside the other team's 10-yard line. So permanent is a minimum. That having been said, I think anything that is not double digit would be disruptive. So I believe that 15 years would be a target, 10 years would be acceptable, but anything less would be really disruptive.

Mr. BAILEY. I think a lot of people struggle with the word permanent, that it's something that can't be undone. So I put in my remarks "sustainable." I think you do start talking about 10 years, 15 years-plus, but something that is sustainable is really what we are trying to achieve in the end.

Mr. ACKERMAN. Mr. Lieber.

Mr. LIEBER. If I may, just from our standpoint, I think 15 years is a minimum, and here is why, is that in large scale development projects, between the time it takes to get a project planned, de-

signed and approved, built and leased up to the point where you are going to be in a position to have takeout financing, could be in excess of—is very frequently in excess of 10 years, so 15 years for a large scale project is really what you need, because you need the construction lender to know terrorism insurance will be there. So there could be a takeout by a permanent lender, and all the other participants in the project.

There is one other variable. It's a little technical, but if you had an act of terrorism, clearly, there would be lawsuits about design defects and was the project physically designed well. The statutes of repose that affect those lawsuits go in—I think in the State of Nevada it is 12 years. In California it is 10 years. So you need the project to be built and for that statute of repose to expire before the exposure, the need to have terrorism backstop, goes away. So it has to be 15 years.

Mr. ACKERMAN. Thank you very much. The Chair hears that his time is up. The distinguished minority leader.

Ms. PRYCE. Thank you. I would love to be the minority leader, but today I am, I guess.

Mr. ACKERMAN. You are today.

Ms. PRYCE. The Mayor and others mentioned the distinction between international and domestic terrorism. Several of you did as well. I don't think we need to look any further than Oklahoma City to see that we can home-grow our own forms of terror, and I don't know where that distinction came from, and I am not sure what sense it makes. But if any of you could comment on that, why—I think it came up in the Senate, did it not? Does anybody have any thoughts? Does anybody here think that it should be only international, foreign? I wouldn't think so.

The other thing that everybody has mentioned is NBCR, and you know, it is very, very hard to predict terror. It doesn't lend itself, especially the NBCR component, to actuarial digestion or modeling, but my prediction is, if we don't cover this in some way, that is exactly where we will be hit. These terrorists are intent on doing as much damage as they can, not only to human life, but to our economy if they see a hole in coverage or see an opportunity. I just think that there is absolutely no way we can go without addressing this.

Does anybody disagree with that?

Mr. KELLY. Distinguished Member, there are two ways to think of the insurance risk, and I think—

Mr. ACKERMAN. Pull that a little bit closer.

Mr. KELLY. I think the Superintendent did an excellent job with his diagram. There is the frequency risk and the absolute scale. The absolute potential loss from NBCR dramatically overwhelms the absolute potential loss from a physical—conventional, if one can think of conventional terrorism.

When we think of hundreds of billions of dollars of loss, that is under either numerous coordinated traditional terrorist acts or a single NBCR attack, so we absolutely have to have NBCR coverage. It is unacceptable, if that is appropriate to say to Congress, but to me it would be unacceptable not to have significant coverage of NBCR.

Ms. PRYCE. One other thing that intrigued me, Dr. Ferguson. You mentioned that there is a difference between a certified act and an uncertified act, and I don't understand that.

Mr. FERGUSON. I am sorry. That is the technical language being used in the Act for this foreign versus domestic story that you just touched on.

Ms. PRYCE. Oh, okay.

Mr. FERGUSON. I'm sorry. I knew as I was saying it that there might be some confusion, but this whole issue that you have raised is right.

I should add that you raise another important issue that, as an economist, I have been thinking about, which is: If you leave open certain areas such as NBCR, that is obviously an area that our enemies could exploit in some way, and so in some sense closing these important risks such as NBCR or the group life issue, I think, is very important, just for the reasons you point out for the incentive effect.

Mr. ACKERMAN. If the Chair might, under the existing Act it is the Secretary of the Treasury that certifies that indeed the incident was an act of international terrorism, rather than something else. The Act is currently silent on an act of domestic terrorism or some kind of combination of domestic terrorists inspired by international terrorists, which we don't contemplate necessarily.

We would have to add language, if indeed we do cover domestic terrorism, as to who would declare it, whether it is the Treasury Secretary or some other authority, but I think the consensus seems to be, starting with the Mayor, that it would make no difference who the attack was caused by. We just have to decide how to put the language in. Mr. Heck?

Mr. HECK. Yes. I would like to say something on behalf of medium and small size companies with respect to NBCR. I suggest that NBCR should be covered by the government, but it should apply as a separate program, and it should apply—it should be covered by the government from first dollar.

The reason that I suggest that is that it is such a serious and complete destructive event that the small and medium sized companies just could not afford to have that exposure for their retentions and for the co-insurance limit.

Ms. PRYCE. Thank you. My time has expired.

Mr. ACKERMAN. Thank you. Ms. McCarthy.

Ms. MCCARTHY. Thank you. I would appreciate just a little bit of clarification on a number, and I hope I have my names down right on who said it.

Basically, actually, it was Mr. Graves who was talking about the life of the loan. Now how long is the life of the loan when you are talking about the kind of monies I think we are talking about?

Mr. GRAVES. The life of the loan can be—they range anywhere from as short as 2 to 3 years to as long as 20 or 25 years. So there is a wide range of loan terms available for commercial properties, and it usually depends on how the property is leased. I would say the most prevalent permanent loan in the market would be 10 years.

Ms. MCCARTHY. Really? So it is not like us paying off a 30-year mortgage?

Mr. GRAVES. No.

Ms. MCCARTHY. Because that is what, actually, I was thinking. If someone else could answer the question on building risk insurance. I am not exactly sure if I know building risk insurance. Is that at the process for like where we were down at the Twin Towers where it has been already spent a lot of money to get to where we are today?

Mr. LIEBER. It insures against damages that may take place during the construction process, and what is happening, the reason I mentioned it, is that although you would get builder's risk insurance without terrorism, and that is really the option that is mostly available to us, what is happening is that because in New York State a builder's risk or a property insurer is liable for a fire following an event.

Some of the builder's risk insurers are, in effect, taking some terrorism risk, even though we don't have—they are not selling us terrorism insurance, because they could theoretically be liable if there is an impact, and then subsequently a fire that causes damage, they could be liable, even though they haven't sold this terrorism insurance. That was the reason I made the point that we should clarify the scope of TRIA to make it clear it covers all the consequences of an attack.

Ms. MCCARTHY. Then just to follow up on one other question: Obviously, everyone is concentrating here on New York, because that is where it happened. That is where we are rebuilding. What do you see as far as other parts of the country on buying terrorist insurance? Have you seen, certainly, an uptick, and what are the cost analyses? Is it like other insurance, like if it was in the middle of Wyoming, are those costs cheaper than, say, here in New York?

Mr. KELLY. Well, the costs vary a little bit, but it is not so much the cost. It is the mindset. I think it is not surprising. We have mandatory offer, which is part of the current law. We get roughly a 60- 62 percent take-up in New York, the Manhattan area, but a 50 percent take-up outside Manhattan.

So people outside the northeast, Manhattan—Manhattan and the northeast have a lot less concern, which, of course, is a political problem, too—have a lot less concern about the impact of terrorism. However, our modeling—and we work with various experts—indicate that some of the greatest exposures are, in fact, outside Manhattan, because people have done a good job of hardening buildings in Manhattan, and in Manhattan large buildings protect each other from events.

Mr. GREEN. The biggest issue is, whether we want to or not get insurance and what is our appetite for risk is really beyond—it is not an issue here, because our mortgages in New York—you have a big office building. The mortgage holder will require you to have a certain amount of casualty, a certain amount of terrorism insurance. We don't have a choice.

Now when you go outside of New York, I don't think the mortgage lenders are as extreme in requiring you to have terrorism insurance, so it is really not a level playing field at all.

Mr. HECK. With regard to cost, there are really two different ways to look at it. The cost on the primary end when we sell an insurance policy to a business, the cost is kept down because of

TRIA, and if TRIA wasn't there, the cost—you would have a risk based cost. It would have to go up if the regulations would permit it.

On the reinsurance end, and that is the insurance that the insurance companies buy, the cost is exorbitant. It is extremely high, and there is a limited amount of reinsurance available, and as Mr. Kelly said, I don't see much distinction from city to city in that expense. It is very, very high.

Ms. MCCARTHY. Thank you.

Mr. FERGUSON. May I speak to this, as the only person here from the reinsurance industry. I think we ought to be a little careful. There are a range of products and services for sure. With TRIA in place, there seems to be sufficient capacity in the reinsurance industry to do backing.

It is certainly true that the pricing may vary somewhat from location to location, but I would be cautious. I think the word exorbitant doesn't fully describe all of the economics of this. So we should be a little cautious about being sure about the pricing between reinsurance and insurance.

Mr. KELLY. One other thing. We keep talking about real estate and property, and that is a huge and important market to us and a very important good. But there is also worker's compensation.

There are people, and there is where it is important we understand it isn't just a matter of protecting, albeit important—protecting the lender. We also have to make sure we protect the workers in the building and that we can put those workers back on their feet or take care of their families in case of disability or death. Let's not lose sight of that hugely important part of TRIA.

Mr. BAILEY. I would just chime in, actually in validation of that. That might be one of the greatest arguments for the fact that this is not just a New York City issue. We have clients all over North America, and where there is a concentration of risk relative to employees in a single location, it is very difficult for us to currently get worker's compensation insurance. You take the backstop away. It would be almost impossible.

Mr. ACKERMAN. Unless there is any objection, the Chair would ask the timekeepers to afford 4 minutes to our Republican colleagues, because to pass this we want to make sure that everybody's questions are answered. Mr. King.

Mr. KING. Thank you, Mr. Chairman. I want to thank all the witnesses for their testimony. I would like to direct my question to Mr. Lieber on the issue that you were talking about, the insufficient capacity, even with TRIA.

Now if I could be clear, if we do resolve the issues regarding NBCR, regarding the foreign and domestic terrorism, and the issue of proximate consequences, how much would that cut into the problem of insufficient capacity?

Mr. LIEBER. It is a very good question. It is impossible to foresee. Those will have significant positive consequences, we believe, as to capacity, permanency, NBCR and the other items that you mentioned.

We believe there will still be—and again, it is based on input from experts and insurance brokers like Aon and Willis—that we are so far from having sufficient capacity that we ought to discuss

some other steps that might be taken to incentivize insurance capacity to come into areas like Lower Manhattan.

Mr. KING. I don't know if this is the appropriate forum, but since Chairman Ackerman gave me 4 minutes, could you just expand on what you think those other steps would be?

Mr. LIEBER. Well, one of the other members of the panel talked about reducing the trigger level where the TRIA Federal backstop kicks in, and you were talking about, I think, in the case of the small insurers, to incentivize them to come in. That, for example, might induce some small insurers who otherwise can't play in this marketplace where you have to, under the current program, wipe out 20 percent of your capital before the Federal backstop kicks in—that might induce them to come in and participate in this marketplace.

More broadly, you know, you could consider adjusting the retentions, the deductibles, for areas that are identified by Congress as high risk.

Those are a couple of the suggestions that we think are worth considering as part of this result.

Mr. KING. Thank you.

Mr. KELLY. Congressman, I think we should take a hard look at the current tax structure as it relates to catastrophe bonds, particularly terrorism bonds. U.S. tax laws sort of end up forcing us to create bond structures overseas in better tax jurisdictions.

If one could look at the tax laws to create—make it easier for us to work with the capital markets and through our reinsurers with them to create cat bond structures, it would fill that layer, that layer between the private sector and the government sector. I think that is an area we need to look at very closely.

Mr. KING. Thank you. Mr. Kelly, sorry I had to jump up when you were answering the question. I just got a—MediGroup called my wife. Everything was fine. We were 50/50. So I will give you and Gary Ackerman the credit for that. Thank you.

Mr. ACKERMAN. I'm glad you got good news.

Mr. HECK. May I say something about the trigger? And just to explain why the trigger at $100 million is so difficult. My company insures buildings. We are a big building insurer in New York. We try to stay at $50 million, no larger than a $50 million building, but we do go up to $100 million on many of our risks.

If we should have an incident with a direct hit to a building we insure that might be $90 million, TRIA does not apply. We would be in serious difficulty, because $90 million would represent a very significant part of our capital structure. So without TRIA, we would have to bring that $50 million way down. That is why it is so important.

Mr. ACKERMAN. Thank you very much. Mr. Murphy, for 3 minutes.

Mr. MURPHY. Thank you, Mr. Chairman. I wanted to explore with a little bit more depth the questions that Representative McCarthy started to query on the difference between this issue in New York City and in outlying areas, because I think politically it is obviously very important to make people understand the national implications here.

I would open this up to whomever may want to answer it, but to talk a little bit more about the difference in capacity of the system to respond in New York and outside of New York, and also the willingness to write for terrorism absent TRIA in New York versus outside of New York.

Mr. HECK. I could begin. One of the reasons that New York City is so vulnerable is that it contains the largest number of the largest buildings across the Nation, so it has more targets in New York. But I think that every large city is vulnerable, and there are some very big buildings in many cities.

Mr. MURPHY. And I guess to maybe ask the question specifically, did we have a problem in the months following September 11th with insurers being unwilling to write for terrorism risk outside of New York as well as inside of New York?

Mr. HECK. I think there was a problem all over. For example, pre-9/11 my company wrote up to $250 million on a single building. After 9/11 we took that limit down to $50 million, and that was true everywhere we did business, which is regional. We are a regional company.

So I think that there is no question that that was an issue. After 9/11, companies in New York withdrew, and even to this day—and you read a lot about the success of the insurance industry last year, and it had been one of the best years for many, many years for the industry, but we do not see more companies coming into Manhattan writing business.

As a matter of fact, the longer we are here writing business, the higher our concentrations, and then we have to refine those concentrations by reducing coverage and non-renewing some business, because all of the companies that are in New York now geo-track everything we write. We know what we have in each building, how many employees reside in the building, and we have to keep track and not permit these aggregations to get too large.

So there is no question about it. It limits the market, and it limits availability.

One of your questions was about how much there is. Recently, I was involved in a single risk on a very, very large building in New York, a very large building, where the risk required $1.3 billion in coverage. The most they were able to get was $700 million with terrorism, with TRIA.

I was called. My company couldn't participate in that; it was too big for us. We wrote a good part of the account, and the producer, the broker, called me to ask whether I had any ideas, and I told him I would try some of the large reinsurers. He had been dealing with insurance companies.

I called the large reinsurers. They seemed interested. They later got back to me to say that they were supporting the primary companies, so they had no more capacity.

What the broker did do was to go offshore and was able to form some sort of an offshore arrangement to get access to TRIA. Then I said to him, "Well, what are you going to do at the end of this year?" He said, "I have no idea."

So there is really a distinct small limit of coverage available on an individual building basis.

Mr. KELLY. There are two thoughts here. Unlike natural catastrophe where there is more than ample insurance and reinsurance coverage to meet anything we can foresee, and that will be solved easily in the private market, but with some bumps along the way.

With terrorism, it is the absolute scale that scares us—after September 11th, it wasn't in property insurance that shortage was found. It was in worker's compensation insurance. We are not allowed by any standard to exclude any act from workers' coverage. All acts, all causes of damage, they must be mandatorily covered by worker's compensation. It is in the insurance of people that the most harmful immediate impact of a lack of TRIA would be felt.

Mr. ACKERMAN. Thank you. Mr. Perlmutter.

Mr. PERLMUTTER. Thanks, Mr. Chairman. Just a couple of questions, gentlemen, and thank you very much for your testimony today.

Mr. Heck, you mentioned on the nuclear, biological threat that you would like to see dollar one. So in effect, no insurance, just something picked up by the Federal Government. Does the rest of the panel join in that? So basically, you are not selling insurance for that. It is just something that we pick up as a whole?

Mr. HECK. I will say that right now the insurance policy for property excludes nuclear. That was excluded sometime in the 1940's, and it has been a complete exclusion since then. The reason for it is that it is certainly uninsurable. There is no way to cover it, and it is complete. If, God forbid, there is a nuclear event, it is a very complete situation, and it is something that none of us can really deal with. It should not really be a private insurance matter.

Mr. PERLMUTTER. I mean, I am new at this. So at this point in TRIA, there is nothing that talks about nuclear. Are you all held responsible in the event of a nuclear event?

Mr. HECK. Under worker's compensation, there is no exclusion for nuclear, and as Mr. Kelly said, the carriers would be responsible for that, so it is a really sensitive subject. The best way to handle it would be to keep it out of TRIA as a separate government program.

Mr. BAILEY. Just a point of clarification. Nominally now, NBCR is within the scope of coverage, but you can't get the coverage; it is just not available. It is an automatic exclusion from any coverage, even terrorism coverage.

Mr. PERLMUTTER. So then at this point, the mortgage bankers aren't demanding it of the real estate developers, who then have to go get the insurance company to provide it?

Mr. GRAVES. We would like it available. It is a risk. It is a risk that we are not being paid for as a lender, so we would strongly encourage the inclusion of that.

Mr. PERLMUTTER. Just one last question. I can't remember who, maybe it was you, Mr. Lieber, or somebody mentioned that group life insurance is not being covered at this point. Dr. Ferguson, maybe that is what you were addressing?

Mr. FERGUSON. Well, it is exactly the same point you have heard with worker's comp. It is again a very large concentration of risk. The exclusions do not exist, and I am not sure of the history of why worker's comp and group life were treated differently, but it would seem they are very, very similar kinds of risk and should be treat-

ed consistently, and it is just that straightforward an argument. But it is extremely important, for the reasons that my friend from Liberty Mutual has talked about in terms of just covering life is very important.

Mr. PERLMUTTER. The last thing, and I know that the Federal Government operates—doesn't account quite the same as all of you must do your accounting, but any sense of what this is a cost to the Federal taxpayers in establishing a reserve?

Mr. FERGUSON. First let's get the facts. As you well know, it has cost absolutely nothing at this stage. It is a backstop. Secondly, the way I would think about it, in addition to this budget scoring issue which, obviously, is fairly complicated, is should an event occur, the government would undoubtedly be involved anyway.

So I think the challenge from a budgeting standpoint is in some sense you create certainty up front by having this backstop. You leave uncertainty with the real probability that, should a very large event occur, the government would step in anyway.

So while it is not in any sense unimportant how the budget scorers account for it, as I think about it as a former government policymaker, it is one of these events where, frankly, because there is so much market failure, the government has to step in. So I think there is really no way to get around that fundamental issue of why the government is required and why I am sitting here today.

Mr. ACKERMAN. Mr. Garrett, 4 minutes.

Mr. GARRETT. Thank you again, Mr. Chairman. You know, I think the first panel and then the members of this panel also made the comment with regard to the number of projects that are out there potentially at risk, and if we don't move forward that they would be certainly subject to risk.

I can assure you from both sides of the aisle that we want to do nothing that would put these projects that are on the board or potentially on the board at risk.

On the upside of all this, you know, both the testimony I have heard today and also from the President's Working Group, you would see that both in the original TRIA and the subsequent extension that you have seen some positive sign from it.

The PWG found that insurers have a better understanding of the geographic mix and the concentration issues that they have to deal with. They are better able to make underwriting and pricing decisions, as testimony has already indicated, and there is more terrorism insurance sold year to year, and financially it indicates in the report that most insurers have policyholder surplus levels that are exceeding those levels of 2001 and, as the report said, that certain industries, certain carriers, are doing pretty well with the profits.

They found that with the extension, the revision of TRIA, that when it was scaled back, the private sector capacity increased, premiums fell, and overall policy purchases called takeup grew as well.

So we have the upside of both the original and revised version of TRIA. One of my findings in government is that we don't do anything unless, especially on complicated issues such as this, unless we are compelled to, either through tragedy or through time. Obviously, we did something right after 9/11, because that was tragedy.

We did something after the 3-year first period time, because that was a time constraint, and we pushed it off—we did it for a 2-year period of time.

I am concerned that, if we do as the bottom line number that the panel comes here with 10 years—others say 15 years; others say a permanent level—that we will not be compelled to come back like we did after the first 3 years and make some improvements to it, and what we are about to do right here is make some improvements to it.

Mr. Lieber, you mentioned also some other ideas of potential improvement besides those. Once we fix a problem, Congress doesn't usually go back and re-fix it unless those issues come up again. I have a feeling that Mr. Lieber and others may come up with ideas 3 or 4 years down the road to re-fix it again in a positive way.

So I am wondering why should we be reauthorizing for 5 times what we just did in this last time, and can't we do it still in this manner?

Secondly, tied to that, if we do do a permanent solution or a long term solution, wouldn't this take away some of the incentives that are currently on the industry to be creative and innovative and try to address some of the problems, as they have done over the last 3- and then 2-year period?

Mr. LIEBER. I will take a crack at that as probably the person at hand who is least expert in insurance matters, technical insurance matters, but I will tell you this. I believe that, if you had a permanent solution, if you had the stability of knowing what the box was, what the rules of the game were, where the Federal backstop was, and that you knew it was in place for a substantial period of time, that would give the opportunity for private sector creativity to come in and help us to resolve some of the shortfalls of capacity, to develop new products, to work on the pricing and the actuarial issues.

So, Congressman, our hope and expectation is that, if you had a stable framework, and we think that it ought to be 15 years—you have heard other views on that—that you would have a lot of creativity and a lot of improvement over time as a result of the insurance industry working with its customers.

Mr. GREEN. If I could just take it back on that a little bit. I have spent my career in the insurance industry and have probably learned a couple of things. Insurance companies, carriers, are not big fans of government involvement in what they do and, too, I would tell you that they are very innovative and creative, and if they can find a way to make a profit on something, they will do it. They will innovate.

In this situation, you have carriers begging for government involvement, because they have not found any way to generate a reasonable profit in this area. So the thought that the private market is somehow going to come up with a solution to this, if we just get rid of TRIA, I think, is just naive. It is not out there.

Mr. KELLY. Congressman, the current Act has led to creativity, because there is significant retention of risk by the industry. The impermanence of the current Act has militated against creativity, because our policies, as Mayor Bloomberg indicated—are not coterminous with the Act.

So we are frozen in place, effectively, starting January of this year. In fact, the impermanency militates against creativity. It is the exact opposite of what you would expect. I believe that with permanency and with the significant retentions we have right now, you will see the private sector continue to work, whether it's real estate customer or employers, to make the workplace safer and to meet whatever is needed in the capital markets below the government involvement.

Mr. HECK. I would also like to add that, at least in New York City, the availability of terrorism coverage other than the coverage that is required under TRIA has not increased in any significant way since 2002. What has improved is the takeup rate, because I think it takes time for the consumers and the business community to get adjusted.

You know, let's face it. On the primary side, we are not charging a lot of money for terrorism because of TRIA. Second, the retentions have gone up, because TRIEA required higher retentions. But in terms of more carriers coming into the market to provide, you know, like reinsurance availability, it is just not there.

Mr. GARRETT. Thank you.

Mr. ACKERMAN. Thank you, Mr. Garrett. Ms. Maloney for 3 minutes.

Ms. MALONEY. Thank you, Mr. Chairman, and I would like to thank all of the members of the panel for your really important contribution. You all represent important stakeholders in this industry, and what you have said today will help us craft a bill.

We are all working on it now. Chairman Frank and Subcommittee Chairman Kanjorski have indicated that they would like a bill drafted and considered by the end of April so that the Senate and the Executive Branch would have time to respond and get an appropriate law in place.

I would like to ask Mr. Green: Since we enacted TRIA, it has proven that it works. Takeup rates for terrorism insurance have increased from 23 percent in early 2003 to 64 percent at the end of 2005, and these are numbers cited by the President's Working Group on Financial Markets.

So my question is: Would this growth, or rather regrowth of terrorism risk insurance have happened without TRIA? And as a follow-up to you and other members of the panel, what is the appropriate role for the private sector in a long term solution?

Mr. GREEN. Let me, in answer to your question, give you a story, real life, it happened, rather than talk about concept and philosophy.

We had a policy. Our total terrorism policy, casualty policy, was expiring on October 31, 2005. If you remember, at that time TRIA was set to expire December 31, 2005. August, early September, we had gone around to many of our insurance companies, Chub, AIG. These are big companies. We have a great relationship, and they have insured us over the years.

At that time, sometime in September—I may get the names wrong, but I believe Senator Phil Gramm from Texas, Secretary Snow was making speeches about the possibility that we needed a free enterprise system to work, and maybe the government should not be part of this solution. Then there was, I think, the chairman

of the Banking Committee in the Senate from Alabama—I forgot his name—Selby was making speeches to this extent.

So all of a sudden, in September, all of our insurance companies would not give us terrorism insurance, because they felt that TRIA was going to end come December 31st. They weren't sure. There was an uncertainty.

We needed it because of our mortgage requirements. We went around to the world, literally to the world. There was one company who came back. I won't mention the name of the company. It is of no value, but a major, major United States, an icon of corporate America came back to us and said they gave us 24 hours. If we did not adhere to what they wanted, which was a $10 million increase to the premiums we were paying then, $10 million more, 24 hours, they would allocate it to somebody else.

We had no choice. We didn't quite say thank you in those terms, but we had to take that insurance. That will give you a real life perspective of what happened with uncertainty that the TRIA backstop was going to be renewed.

Mr. ACKERMAN. Thank you, very much.

Ms. MALONEY. And if anyone would comment on the appropriate role for the private sector in a long term solution, anyone, Mr. Green.

Mr. ACKERMAN. Briefly.

Mr. GREEN. I think Mr. Lieber had a good recommendation. We believe in competition, Democrat, Republican. We love the free enterprise system to work. That is our goal. And if you want the free enterprise system to work and insurance companies to come into this market, reduce the $100 million deductible so that companies—this gentleman, I think, said it well.

His company—if you can only do a $50 million building in New York, you can't insure very many buildings. I think, if you reduce that, smaller companies would come in, and you would have increased competition and increased product.

Ms. MALONEY. Thank you.

Mr. ACKERMAN. Thank you, very much.

With great appreciation to all involved, let me just add one thing to the mix that we all are going to give some consideration to, and that is post-event occurrences.

If indeed we do positively consider the chemical, biological, and radiological losses that might occur, we don't know exactly what we are talking about because of things that could happen, depending on what kind of weapons might be used in the attacks, new things that come along, and how and when they manifest themselves.

We are all going to have to give some considerable thought to that. Is there something like in the medical profession where they have tail insurance that months or years or years or more years after an event people start getting sick from something that we don't even know about today, the results of the unknown, about the unknown and how we deal with that.

This is something that we may have to take up. This is something that you may want to think about. In the meantime, we promised to have the committee out of here and on buses and other transportation before one o'clock.

I want to thank this very distinguished panel. You have each individually and collectively lent to the base of knowledge that we have as we ponder what we are going to do with the reauthorization of this bill.

I thank you for participating. The panel is dismissed with the thanks of the Chair and the Congress, and this hearing is adjourned.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

A P P E N D I X

March 5, 2007

STATEMENT SUBMITTED

BY

DON BAILEY, CEO OF WILLIS NORTH AMERICA

TO

HOUSE FINANCIAL SERVICES COMMITTEE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT

SPONSORED ENTERPRISES

ON

THE TERRORISM RISK INSURANCE PROGRAM

March 5, 2007

Chairman Kanjorski, Ranking Member Pryce, and members of the Subcommittee, thank you for the opportunity to testify before you today regarding the terrorism risk insurance program. My name is Don Bailey. I am the CEO of Willis North America, Inc., a subsidiary of The Willis Group (Willis). My testimony today is on behalf of my firm, as well as the member firms of the Council of Insurance Agents and Brokers (The Council).

Willis is one of the world's largest professional services firms specializing in risk management. Our 15,400 experienced and highly knowledgeable employees provide a wide range of strategic and operational risk management services across all industries, worldwide. The Council represents the nation's leading, most productive and most profitable commercial property and casualty insurance agencies and brokerage firms. Council members specialize in a wide range of insurance products and risk management services for business, industry, government, and the public. Operating both nationally and internationally, Council members conduct business in more than 3,000 locations, employ more than 120,000 people, and annually place approximately 80 percent – well over $200 billion – of all U.S. insurance products and services protecting business, industry, government and the public at-large, and they administer billions of dollars in employee benefits. Since 1913, The Council has worked in the best interests of its members, securing innovative solutions and creating new market opportunities at home and abroad.

Willis and the members of The Council share your belief that terrorism risk protection is an issue of utmost importance and a critical element in our Nation's efforts to confront and defeat the terrorist threat. The members of this Subcommittee have been leaders in this effort and we commend you for all of your hard work, including the adoption of the Terrorism Risk Insurance Act (TRIA) in 2002 and the Terrorism Risk Insurance Extension Act (TRIEA) in 2005.

Introduction

It has been more than five years since thousands of our fellow citizens, our friends, colleagues and family members, were killed in the September 11, 2001, terrorist attacks. For many Council members, the loss was personal, and our industry lost many good people that terrible day.

One of the most important of the many steps that Congress and the President have taken to protect Americans from the effects of terror attacks was the enactment of TRIA in 2002, and its extension in 2005. Passage of TRIA was critical for individual businesses and for the economy as a whole. Although the spotlight was on the insurance industry's capacity to withstand further terror attacks and to cover terror risks going forward, the national risk was – and is – much broader. Because insurance provides individuals and businesses with the ability to take risks essential to the functioning of our economy, constraining that ability would be economically devastating. TRIA has prevented that from happening. Indeed, not only have federal funds provided by the TRIA "backstop" never been tapped and not one taxpayer dollar spent, the program has proved to be an unqualified success in stabilizing the insurance markets, allowing insurers to provide much-needed terrorism coverage to consumers at prices they are able to afford. TRIA is not about protecting the balance sheets of insurers and brokers – it is about protecting commercial policyholders and creating and sustaining a national economy that encourages investment and development.

When TRIA was originally adopted in 2002, the assumption of many was that the private sector would be able to create a market for terror insurance coverage and the federal program would be a stop-gap measure to ensure stability while that market developed. Since that time, however, it has become clear that the private sector – insurance companies, the capital markets

and rating agencies – have a very limited ability to insure and rate terrorism risks that are only questionably quantifiable, totally unpredictable and, essentially, impossible to underwrite. This is further exacerbated with respect to coverage of nuclear, biological, and radiological risks (NBCR), for which coverage is essentially non-existent even with TRIA in place.

Given these realities, Willis and the members of The Council believe a long-term solution to the terrorism insurance crisis is essential and that the federal government will have an important role to play in terrorism risk coverage for the foreseeable future. The insurance market needs some level of stability and predictability. The prospect of TRIA's demise – or the uncertainty that would come with periodic renewal or extension of the program every few years – is not viable for the long-term. Failure to implement a long-term or, ideally, a permanent fix before TRIA expires at the end of the year will not only vastly decrease risk transfer options, it will expose the U.S. economy to potentially devastating uninsured economic loss in the event of another catastrophic terrorism attack.

The issue before Congress, then, is not whether the government will be the insurer of last resort in the event of such an attack, but rather whether the government will work with the insurance industry to thoughtfully and deliberately develop a plan before an attack to maximize private sector coverage of the massive damages that will result from a terror strike, rather than reacting in crisis mode after an attack occurs. Any such plan must encompass NBCR risks that – today – are almost completely uninsured.

We do not have to look far to see what can happen in the aftermath of a catastrophe in the absence of proper financial preparation. New Orleans remains a disaster nearly 18 months after Katrina struck. Pouring billions of dollars into the Gulf Coast in a non-directed and uncoordinated way has not brought that great American city back. In the event of a terrorist

attack, we know the federal government will step in to provide assistance, particularly if there is insufficient private sector relief. But without TRIA or some sort of federal involvement enabling the private insurance market to be involved in providing terror coverage, you lose all that the insurance industry has to offer: direct contribution through upfront premium payments, relief delivery through established claims processes, and a repayment mechanism through policyholder surcharges after the event. So it is not a question of whether the federal government will pay, but rather whether the federal government will work with the insurance industry to ensure that the preparation and response to a terrorist attack is handled in the most efficient way possible. Better TRIA than FEMA.

Insurance Brokers' Interest in Terrorism Insurance

The role of insurance agents and brokers (producers) in general, and Willis and Council members in particular, is to help our clients manage risks and secure the insurance coverage they need to protect them from the risk of loss. We primarily serve the needs of commercial insureds, who are the major policyholders of terrorism risk insurance. Commercial policyholders are represented in the TRIA debate by the Risk and Insurance Management Society (RIMS) and the Coalition to Insurance Against Terrorism (CIAT). These groups are not to be confused with the Consumer Federation of America (CFA), which, despite its claims, has a much more limited stake in the issues surrounding terrorism risk insurance coverage. As the insurance experts closest to insurance consumers and the insurance marketplace, we understand our clients' needs and the needs and appetite of the market, and thus bring a unique perspective to the discussion of terrorism insurance coverage. Commercial insureds need terrorism coverage not just for piece of mind, but for their businesses. Indeed, in many cases, purchase of terrorism coverage is

mandatory – it is required to obtain a mortgage or financing for new construction, the expansion of a business or a new entrepreneurial venture, sometimes by state laws and regulations, and often by contract.

The most important issue for the broker community, therefore, is maintaining consumer access to coverage at a price the business consumer can afford. In order to get this access, we need insurers who are able and willing to provide the coverage. It is clear that they cannot and will not be able to provide terror coverage without a federal backstop or some other mechanism to cap their exposure.

Let me be clear: Willis's business is not dependent on any federal backstop. We will continue to help our clients mitigate their risks with all the best means available. But insurance is an important component in a comprehensive risk management program, and the availability and affordability of terror coverage is a critical issue for our clients and the U.S. economy. We supported TRIA in 2002 and 2005 and do so again today because of our clients' need for terror coverage, the lack of capacity in the private market, and the high cost of the small amount of coverage that was available absent TRIA. For the same reasons, and because TRIA successfully brought stability to the private market for terrorism risk insurance, Willis and the Council believe the creation of a long-term or permanent solution to the terrorism insurance affordability and availability crisis is essential. There is no more important policy issue for Council members.

The Success of TRIA and TRIEA

Since its inception in 2002, TRIA has been incredibly successful in providing the commercial property and casualty market, and insurance buyers, with increased terrorism capacity and in significantly decreased prices without costing taxpayers one dollar. In addition

to providing readily available and affordable terrorism capacity for U.S. based risks, the program has also allowed the private market to progressively increase its role in coverage terrorism risks through retained terrorism exposures under TRIA.

Coverage that is both available and affordable is directly due to the existence of the federal backstop. Since TRIA's enactment, as the availability of terrorism coverage has grown and premium prices have dropped, take-up rates for terrorism coverage have steadily increased. A brief history of the terrorism insurance marketplace since 9/11 illustrates TRIA's success:

- Prior to September 11, 2001, terrorism risk was considered minimal and coverage for terrorism was generally included at no additional cost in most property and casualty policies.

- After September 11 and prior to the enactment of TRIA, terrorism insurance became almost entirely unavailable, and the small amount that was available was prohibitively expensive. The lack of coverage for terrorism risk at a time when the perceived risk was enormous resulted in uncertainties whose effects rippled far beyond the insurance industry.

- In the months after enactment of TRIA, the initial pricing for terror coverage was high and the take-up was low.

- Since that time, the purchase of terrorism insurance has been steadily increasing. For example, in 2003, the first full year of the program, less than 40 % of large- and mid-sized U.S. businesses, according to some estimates, obtained insurance to cover property terrorism risks. That number has jumped to more than 60% today.

- The increase in take-up rates reflects the increasing demand by America's business community for terrorism coverage at commercially viable prices. Statistics show that the average rates for terrorism coverage dropped 25% between 2004 and 2005, and another 25% between 2005 and 2006, providing much-needed stability to the market. This is because of the "make available" provisions in TRIA and TRIEA. Affordable terrorism coverage has allowed numerous business transactions that would otherwise have been stalled to go forward, without threatening the solvency of the parties involved or their insurers. Policyholders – the businesses of our economy – have not had to deal with extremely high— and volatile — terrorism insurance costs and have been able to budget for their business plans.

- Statistics also show that terrorism risk is not limited to urban, coastal areas and is not limited to particular industries. Industry reports indicate that the take-up rates are high across the country and across industries, and policyholders are generally willing to purchase terrorism coverage when it is available at an affordable price. For companies with a higher perceived risk, whether due to size, location, industry or other factors, the take-up rates are even higher. According to industry reports, take-up rates were highest in the Northeast and Midwest, followed by the South and West. Within specific industrial sectors, the largest percentage of insureds buying terrorism insurance were in real estate, financial services, health care, media, hospitality, transportation and education. Even companies in the sectors with comparatively low take-up rates – energy and manufacturing, for example –

each had take-up rates exceeding 30% percent in 2006. These relatively high rates show not only demand, but that we are making progress toward the public policy goal of encouraging coverage in affected areas and industries. By comparison, in California – where the likelihood of a major earthquake can be better modeled, understood and underwritten – price and complexity have capped take up rates of earthquake insurance at only 11%.

Where We Stand Now

Unfortunately, despite the success of TRIA and TRIEA in stabilizing the terrorism insurance market, the basic facts that prompted the enactment of TRIA and TRIEA in the first place have not changed and still call for federal involvement in providing terrorism insurance after the expiration of TRIEA. Although the particular ways of federal involvement are open to discussion, some sort of federal involvement has to be preserved in order to avoid the potentially devastating effects caused by the expiration of TRIEA. This conclusion will be obvious if we consider the following facts:

First, the treat of terrorism remains unabated and unpredictable. More than five years after September 11, we have been fortunate enough to not have had another terrorism attack on the American soil. Nonetheless, terrorism attacks elsewhere in the world since September 11 — including the bombings in Madrid and London— remind us that terrorists could strike any time, at any place. The continuing conflicts in Iraq and Afghanistan make the security situation even worse.

Second, without the federal involvement, reinsurers would be unable to quantify the risk and would have to effectively withdraw from the terrorism reinsurance market.

This conclusion was true when TRIA and TRIEA were first enacted, and remains true today. The private reinsurance industry paid about two thirds of the roughly $33 billion insured losses related to 9/11 claims. After September 11 and prior to TRIA, the reinsurance industry withdrew from the terrorism reinsurance market due to the huge and unpredictable terrorism risk. Today, despite the success of TRIA and TRIEA over the past several years, the reinsurance industry estimates that there is only about $6 to $8 billion in global terrorism reinsurance capacity available, and only $1 to $2 billion in capacity available for nuclear, biological, chemical and radiological (NBCR) coverage. This current capacity is nowhere near the level needed to adequately insure our economy against terrorism risk without the TRIA backstop. It is estimated that terrorism losses could reach $100 billion and that losses from a large NBCR attack in New York City alone could reach $778 billion. Without the TRIA backstop, private reinsurers would want as little exposure to terrorism risk as possible. Indeed, even with TRIA backstop now, reinsurers are not meeting the capacity demand of primary insurers for their deductible and coinsurance layers.

Finally, without TRIA backstop or adequate reinsurance coverage from reinsurers, primary insurers are reluctant to expose themselves to potentially unlimited terrorism risks. We saw this quite clearly the last time when Congress was debating whether to enact TRIEA and extend TRIA, in 2005. Back then, primary insurers were including "springing exclusions" that would have voided terrorism coverage beginning January 1, 2006, had TRIEA not been enacted. A Moody's report indicates that 50-75% of all policies written prior to TRIEA's enactment included such exclusions. Now, with the possible expiration of TRIEA at the end of 2007, all primary insurers are again asking

policyholders in the market shopping for policies that run past the end of 2007 to accept those springing exclusions in their insurance policies. It is obvious that if TRIA were allowed to expire after 2007, a large percentage of those policyholders who have no choices but to accept those springing exclusions would see their terrorism risks uninsured—and their business plans disrupted or even put to a halt as a result.

Ways Forward

The purpose of my testimony today is not to discuss any particular plans in details. We understand that there will be a lot of issues, whether we will choose to modify and extend the current TRIA program or to create a different long-term private market solution. We just want to emphasize that the path forward should be carefully chosen based on considerations of economic realities, and whatever we choose to do, we need to do it with inputs from all relevant players—the government, the policyholders, the insurers and reinsurers, and the brokers.

Going forward, there are essentially three options: (1) take no further action and let TRIA expire; (2) modify and extend the current TRIA program; or (3) take a new approach aimed at creating a permanent private market solution that allows TRIA to sunset.

Considering the inability of the insurance industry to handle terrorism risk on its own, as discussed in detail above, we believe that the first option is not an option at all. Simply letting TRIA expire would throw our economy back to the post September 11 and pre-TRIA era and undo the progress we have made in the past five years under TRIA and TRIEA.

The second option, or the first "real" option, is to modify and extend the current TRIA program. Extending the life of TRIA, expanding the program to better encompass NBCR exposures and readjusting its terms to address the changed parameters, will keep terrorism coverage available and the market and economy stable, which would continue the positive trends I outlined earlier. For example, we believe the dollar threshold and the applicable lines of coverage included within the program merit review although any change must recognize the financial abilities of smaller insurers.

Another option is to create an alternative permanent private market solution. We are aware of a number of proposals circulating which envision a pooling arrangement. Such a mechanism could allow the insurance industry to essentially "backstop" itself, by growing the capacity to handle a catastrophic terrorism attack like those of September 11. The existence of a terrorism insurance pool and backstop may provide insurers with a reinsurance vehicle that will allow them to further expand capacity. Growth in capacity will stabilize prices and decrease the need for the federal backstop over time until the government's potential liability is zero.

Conclusion

We have come a long way since TRIA was first enacted. With the help of TRIA, the terrorism insurance market has been largely stabilized, the terrorism coverage has been steadily expanding, and the price of coverage has been becoming more affordable. All of this provided relief that is essential to the smooth functioning of our economy. Best of all, we have managed to achieve all of this without tapping any taxpayers' money.

Despite the success of TRIA, now is not the time for the federal government to withdraw

its involvement in the terrorism insurance market. As seen above, the terrorism threats facing our country remain significant and unpredictable, our reinsurance industry still lacks sufficient capacity to address terrorism risks on its own, and the primary insurers are still not willing to expose themselves to enormous terrorism risks without charging prohibitively high prices. Allowing TRIA to expire at this time will certainly cripple, if not completely paralyze, a non-insignificant portion of our economy. It is our duty, we believe, to keep that from happening.

Once again, we commend you for holding this important hearing today.

Testimony of the
New York State Insurance Department

Before the
Committee on Financial Services
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises
United States House of Representatives

Regarding:
Extension of a Terrorism Risk Insurance Program

March 5, 2007

Eric Dinallo
Acting Superintendent of Insurance
New York

Introduction

Chairman Kanjorski, Ranking Member Bacchus, Members of the Committee, thank you for inviting me to testify today before this Committee. My name is Eric Dinallo. I am the acting Superintendent of Insurance for the state of New York. I'm here today to provide our views on the role of the federal government in a terrorism risk insurance program.

The question before us is what is the best way to deal with insurance protection from the threat of terrorist attack and specifically what role should the federal government play. I would like to make a couple of general points and then some specific recommendations about the proposed legislation.

Sadly, the threat of terrorist attack remains very real and there is no reason to believe that it will end any time soon. In dealing with the appropriate response to this threat, we must always remember that these are attacks aimed at our country as a whole. New York City and Washington were chosen as targets on 9/11 in order to have the maximum impact on the U.S. as a whole. New York City was chosen because it is the financial capital of the U.S. and the world. The terrorists hoped that by striking at the World Trade Center, they could with one blow disrupt the entire American economy.

It turned out that they could bring those two buildings down. But they did not destroy our economy or New York City or our financial markets. There is every reason to believe that New York continues to be a target for the same reason – hitting New York is a way to affect the whole country. That is the same reason that other major cities and ports remain prime targets.

My point is that terrorism insurance is an essential issue for New York. But it is not only a New York issue. This threat is not limited to our urban or economic centers and is not

just a "big city" issue. Any attack, regardless of its location, is an attack on America. An attack on Wall Street, or the Port of San Francisco, or oil refineries in the gulf coast, or the Mall of America will not just have a local or regional impact, but will reverberate throughout the nation with significant ramifications on our national economy. As we increase security levels at locations that are obvious targets, there is the risk that terrorists will seek out softer targets in our suburban and rural areas. In other words, the terrorists' choice of location to attack is simply a function of means and opportunity and our entire nation is at risk. Any response to this risk must also be national in scope.

The nation appropriately understood the attack on the World Trade Center was an attack on all of us and appropriately responded by spreading the costs of that attack on all Americans.

That brings us naturally to insurance. The role of insurance is to allow us to share or pool risk. We all buy home insurance so that if one of us has a fire, the loss does not wipe that one family out. The insurance industry has developed very sophisticated models to determine the risk for any given type of loss so that they can charge appropriately to provide a given type of coverage.

The problem with terrorism is that it is by its intention unpredictable. Insurers set prices or premiums by looking at past experience to predict future size and frequency of losses. But they lack such information about terrorist attacks. Some information is for very good reasons kept secret by government agencies.

We have been fortunate in that our experience with terrorism is limited, but the paucity of data on terrorism, as well as the potential magnitude of loss in the hundreds of billions of dollars, hinders the insurance industry's ability to appropriately price and provide such coverage. But even if you could build a database of all past terrorist attacks, there is no reason to believe that such past information would be of significant help to accurately predict future attacks and their frequency. The goal of terrorists is to find new ways to attack that will cause the most possible damage and disruption

Let's look at what that means concretely. One way to look at pricing for risks is by using a curve to represent all the possible losses. The bottom or horizontal line represents different possible losses – the farther out the line to the right, the larger the loss. The vertical line represents likelihood of each amount. Lower losses are relatively likelier because terrorist acts are rare. The curve lets you determine the mean or average loss and the industry will use that to set its premiums.

The problem is that terrorism adds a very long tail to the curve. Terrorism adds a small number of possible losses that are very, very large. For example, in March 2006 the American Academy of Actuaries provided a statement estimating that a large NBCR (nuclear, biological, chemical or radiological) event in downtown Manhattan could cause insured losses (property/casualty and group life insurance) of $778 billion dollars. Obviously, even a small number of huge possible losses of that size will substantially increase the mean, pushing premiums to unaffordable levels.

What the federal backstop does is eliminate the very, very large losses and thus cuts off the tail. That substantially reduces the mean and thus reduces premiums that insurers must charge and makes them more affordable.

Let's look at the alternative which some advocate, a pure market solution to terrorism insurance. What that would mean is that insurers would have to charge to cover the largest potential risks. Prices would have to rise substantially. Effectively, only those who absolutely had to buy terrorism insurance would do so. This is known as adverse selection. For example, when this happens in health insurance, only the very sick buy health insurance and the cost gets higher and higher for those who most need the coverage.

So, only businesses in New York City, Washington, Chicago, Houston and other large cities seen as targets would buy terrorism insurance. Thus, instead of the risk being shared or pooled, it would be concentrated. That would increase the cost of doing business in our largest cities and hurt their ability to compete with cities in other

countries, especially those which do provide a government backstop for terrorism insurance.

That assumes that the private market would even be willing to offer terrorism insurance. Given the huge risks and the lack of information, many insurers would simply not offer coverage or price it so high that it would amount to the same thing.

People have a healthy skepticism about any kind of subsidy. Critics fear that the government's assistance will encourage risky behavior. In other words, people will take risks they would not otherwise take because they don't have to consider the true cost. Economic theory calls that moral hazard. In insurance, that is called morale hazard. It is to reduce morale hazard that, for example, people who smoke cigarettes pay more for life insurance and auto insurance policies have deductibles to discourage reckless driving by insured motorists.

But the people of New York didn't make a bad decision by choosing to make our city the world financial capital. The fact that New York is the financial capital of the world is not a risk factor that can or should be mitigated. In fact, having the world financial capital in New York and not in another country is a very major asset for all Americans.

New Yorkers take rational steps to reduce the risk of terrorism. New York State and its business community spend billions of dollars to prevent future terrorism related risk, despite the presence of TRIA.

But there is no way to completely avoid the risk. It is not a realistic to spread the financial services industry throughout the country, so there is no one financial capital vulnerable to attack. There are still many strong benefits to concentration. That's why the competition for New York comes from other financial centers, such as London, Tokyo and Hong Kong. And if New York is no longer the world financial capital, the alternative is not going to be another city in America, it's likely to be one of those foreign cities that are already competing for that title.

I don't believe in letting the insurance industry completely off the hook. Quite the opposite, it is essential that we continue to take measures to increase the private markets ability to take on as much terrorism risk as possible. The current legislation does give the industry a substantial role. That's appropriate and we should continue to work to increase it. For example, I would like to see the reinsurance industry get involved. That's more difficult because reinsurance is largely unregulated. I think it would be a mistake to hold up this legislation until we find a solution to that problem. But I am eager to work with others on solutions.

So now let me turn to the specific issues surrounding the proposed legislation. Given the vital role that the Terrorism Risk Insurance Act (TRIA) and the Terrorism Risk Insurance Extension Act (TRIEA) have played in ensuring the affordability and availability of terrorism insurance in the market, and by extension the overall US economy, we cannot and should not lower our economic preparedness by allowing TRIEA to expire without an appropriate federal backstop being in place on January 1, 2008.

The Economy Depends on Terrorism Insurance

Today, TRIEA is quickly approaching its expiration date. Our commitment to the need for a federal backstop as an essential underpinning of our national economy has not changed. My fellow State commissioners and I continue to believe the United States economy remains vulnerable to terrorist attack and requires insurance to help manage exposure to that very real, very unpredictable, and very volatile risk. If some federal backstop is not in place by January 1, 2008, we may revisit some of the same market disruptions and economic uncertainties we faced in the aftermath of September 11 - especially since the private market still does not have the means and the capacity to appropriately address this exposure and its magnitude. Without a federal backstop, property insurance, especially in our urban cities, will become unavailable or unaffordable. Trophy properties across the nation, including hospitals, stadiums, and government buildings, will be significantly impacted and real estate and construction

projects could come to a standstill. The uncertainty surrounding the expiration of TRIEA also affects our competitive position internationally. Other nations with serious terrorism problems have permanent programs in place to ensure terrorism insurance is available. A long-term American solution to the terrorism exposure is long overdue.

TRIA and TRIEA have worked exactly as intended by making terrorism coverage available to those who need it. More businesses are insured for terrorism now than ever before, as evidenced by an increased take-up rate (that is, the rate at which companies have purchased terrorism insurance coverage) for terrorism coverage since the passage of TRIA. As mentioned in the President's Working Group on Financial Markets (PWG) report on terrorism insurance, the "take-up" rate has increased from 27 percent in 2003 to nearly 60 percent in 2005, while the cost for that coverage represents about 3 to 5 percent of the total cost of property coverage. Indeed, in areas of perceived high risk -- the commercial real estate, construction, and financing markets among others -- depend on the availability of terrorism insurance coverage that likely would not exist without a federal backstop.

Terrorism Insurance Depends on Private Market Partnership with the Federal Government

As I indicated before, insurance depends on an estimation of future loss costs which in turn depends on an understanding of frequency and severity for a particular event. While insurers, reinsurers, risk modelers and others have made strides in improving their tools for deriving this information, it is still impossible to accurately apply insurance principles to the risk of catastrophic terrorism. The notion of frequency, in particular, is very difficult to estimate because a terrorist attack is not a random event. The events of September 11, orchestrated by a mere 19 terrorists, illustrate the severity of terrorism events. It was the third costliest insurance event in modern times resulting in nearly $21 billion in losses.. When considering these events in the context of a nuclear, biological, chemical, or radiological (NBCR) event, the severity becomes even more troubling. The NAIC held a public hearing on terrorism insurance matters in March 2006 at which the

American Academy of Actuaries provided a statement estimating that a large NBCR event in downtown Manhattan could cause insured losses (property/casualty and group life insurance) of $778 billion dollars.

As Congress considers the ramifications of what a $778 billion dollar event would do to the insurance industry, it is important to have an understanding of the capacity of the market. As the PWG report also noted, the capacity of the market has increased since 2001. Insurance capacity is generally measured by determining the amount of capital available to insurers to support their policy writings. Using that measure, NAIC data shows that in 2005 aggregate capital for property and casualty insurers was $427 billion. It should be noted however, that that number is the total capacity for the market, for all property/casualty lines. Less than half of that capital is used to support the insuring of commercial enterprises, and the capacity of any one company is far less. Unknown frequency, coupled with the potential for severe losses, make it virtually impossible for insurers to provide coverage for acts of terrorism.

We believe the presence of the federal backstop has provided an appropriate mechanism for the insurance industry to make vital terrorism coverage widely available to American businesses. By requiring insurers through the "make available" mechanism to offer coverage for acts of terrorism they otherwise might not have offered, the federal backstop has been successful in bringing certainty to the insurance marketplace.

As was the case when the initial program was set to expire in 2005, insurance companies and insurance contracts are already affected by the possible expiration of the current program. Terrorism insurance coverage as insurers offer it today is typically contingent on a federal backstop, and insurers will again place limitations on commercial policies to exclude terrorism coverage if a federal backstop no longer exists. These limitations will greatly reduce terrorism coverage in the states that have approved them. In those states that have rejected these coverage limitations, insurers will have to make the difficult choice of writing the coverage and accepting the potentially catastrophic terrorism

exposure or not writing it at all. This could lead to availability and affordability problems down the road.

Congress Should Continue A Terrorism Risk Insurance Program

TRIA and TRIEA are examples of a partnership between the private and public sectors to solve a problem that neither can handle alone. Given our economic dependence on terrorism insurance, and in the absence of a private market solution to make managing this risk practical, I urge immediate action by Congress on a federal measure to ensure continued marketplace stability when TRIEA expires at the end of 2007. Because some terrorism risks are largely uninsurable without a financial backstop, state regulators are very concerned that significant market disruptions will develop before the program's expiration, due in part to timing of the business cycle for insurance renewals.

The commercial insurance business cycle operates in such a way that insurers and their policyholders are required to make decisions now that extend well into 2008. These decisions must reflect the possibility that a federal backstop may cease to exist. For this reason, state insurance regulators have observed widespread insistence by insurers that conditional policy exclusions for terrorism coverage be included in renewal policies. This is the same situation we encountered in the aftermath of September 11, which prompted enactment of TRIA. While this particular dynamic is not present in the New York marketplace, the few states that have not allowed insurers to file coverage limitations fear that without a federal backstop, insurers will be unwilling to underwrite many businesses that want appropriate and reasonably priced terrorism insurance coverage. In my own state, New York, since conditional policy exclusions for terrorism are not permitted, as we draw closer to the December 31 sunsetting of TRIEA, some insurers may review individual underwriting decisions on annual policies that renew throughout 2007, since the possibility of termination of the federal backstop may result in unlimited exposure in 2008.

To address this situation Congress should act to ensure the existence of a federal backstop program. As the private market continues to improve its tools and resources to manage terrorism risk, there may be an opportunity for the private market to assume more risk. And let me be clear, I am not satisfied that private insurers are doing all they can or should do in this area. But even if they were doing everything they should, given the potential for such enormous losses, a federal backstop at the extreme catastrophic level would still be necessary. An individual terrorist attack on American soil may only directly or physically affect a finite area or group of people, but the American public and the federal government have made it clear that we will interpret and respond to any such attack as an attack on our nation as a whole. Knowing that this is and will continue to be the case, a federal role in partnering with the private market to insure acts of terror is an inevitable and therefore ongoing obligation.

The NAIC Continues to Work on Terrorism Insurance Solutions

Following enactment of the Terrorism Risk Insurance Act (TRIA), the National Association of Insurance Commissioners (NAIC) established a Terrorism Insurance Implementation Working Group, chaired by New York, that has worked closely with the Treasury Department and insurance companies to successfully implement TRIA's provisions, as well as to monitor the impact it has had on the insurance marketplace. The Working Group continued that involvement in 2005 when the program was set to expire and supported its extension through the Terrorism Risk Insurance Extension Act (TRIEA).

My fellow commissioners and I, once again, stand ready to assist Congress in developing an appropriate method for continuing a federal terrorism reinsurance backstop. The NAIC continues to discuss the challenges of terrorism insurance at its national meetings and in public hearings, and we are committed to maximizing the participation of the private market in this obligation. As Congress contemplates the expiration of the current program, there are a few issues and concepts that should be considered in addition to, or in conjunction with, a federal reinsurance backstop:

Length of Program

The duration of any successor program to TRIEA should be long enough to provide sustained stability that reflects the commercial insurance cycle as well as sufficient time and means for the private sector to build the appropriate capacity.

Domestic Terrorism

Any successor program to TRIEA should not make a distinction between domestic and foreign acts of terrorism. Both types should be covered. The effects of a terrorist act will be equally devastating regardless of whether such act was perpetrated by an American citizen or foreign national. I urge you to give this matter serious consideration in light of the fact that many perpetrators of the London train bombings last year were born and raised in the U.K and are British citizens.

Tax-Deferred Catastrophe Reserves

One concept that could potentially allow for more private market terrorism insurance capacity, and therefore a lessening of the government's role, is the development of tax-deferred catastrophe reserves. Currently, terrorism premiums collected by an insurer, in the absence of any terrorism losses, become part of the insurers profit and can be paid out in dividends. There are no current requirements for insurers to set aside such premiums in reserves and in fact, federal taxation rules provide insurers with no incentives to create such reserves. By establishing tax-deferred reserves that could be used only for catastrophic losses of a certain magnitude, companies could be encouraged or required to hold a portion of that money and let it grow over time. In essence, private insurers could create their own backstop funds that would be available for catastrophic events. Tax-deferred reserves would put more of the responsibility on policyholder dollars, which are correlated with risk, rather than taxpayer dollars, which are not correlated with risk.

Although challenges exist in how these reserves are structured and monitored, they are common throughout the world for various catastrophic policies.

Workers' Compensation and Group Life Insurance

There are two major types of insurance that cause insurers special concern about whether they can continue to underwrite them without some form of partnership with the federal government. Workers' Compensation and Group Life Insurance are vulnerable to geographically centralized events and this problem can not be addressed solely by the private market. Workers' compensation is a property-casualty product that provides coverage for work-related injuries, illness, and death. It covers lost wages, provides unlimited medical benefits and, in most states, provides rehabilitation benefits to get injured workers back on the job. In the event of death on the job, worker's compensation provides monetary death benefits to the surviving spouse and children. It also provides employers with liability coverage if an employee pursues legal action against an employer in court. Workers' compensation is currently included under the federal backstop.

State laws do not allow an insurer to exclude or limit worker's compensation coverage, except as permitted by state law. As a result, an insurer underwriting this risk without adequate reinsurance is subject to a large potential loss if there are a significant number of employees at a single location. The American Academy of Actuaries estimates that "a modest-sized insured with 200 employees could easily generate a terrorism related event of $50 million. This presumes death of all employees and a typical death benefit of $250,000 per employee.[1]" The absence of a federal backstop program could cause significant instability to the workers' compensation market due to the potential effect of terrorism losses.

[1] American Academy of Actuaries, P/C Extr me Events Committee May 4, 2004 Report, P/C Terrorism Coverage: Where Do We Go Post-Terrorism Risk Insurance Act?, Page 14.

Like workers' compensation, Group Life Insurance coverage is vulnerable to geographic risk concentration problems. For example, if a business has 1,000 employees at a given location, the pricing employed by life insurers for group products probably assumes that three or four employees might die in a given year. If instead, a location with 1,000 employees is hit by a terror attack and all of them die, the insurer has an enormous financial exposure from a single occurrence.

Unlike worker's compensation, there is no statutory requirement for group life that prohibits an insurer from limiting available coverage for acts of terrorism in some fashion. However, insurance regulators are not inclined to approve exclusionary or limiting language in those states that have approval authority over the wording in traditional group life insurance contracts. Further, employers are reluctant to purchase coverage that contains such exclusionary language and employees would not be able to rely on such coverage in their financial and estate planning. Although there is some level of private reinsurance available for group life coverage, it is not sufficient to cover catastrophic terrorism losses. Given the potential solvency threat that a major act of terrorism would present to group life insurers, the NAIC adopted a resolution in June 2005 urging Congress to include group life coverage in any federal backstop program.

Insuring Nuclear, Biological, Chemical, and Radiological (NBCR) Events

In Japan in 1995, domestic terrorists orchestrated a sarin nerve gas attack in the Tokyo subway system that killed twelve people, injured nearly one thousand, and caused massive disruptions to the city. This was the work of just ten men with only a few liters of sarin gas. Our country has thankfully avoided a massive NBCR terrorism event, but we would be naïve to assume that such an event is beyond the realm of possibility. Indeed, the Congress knows all too well the reality of chemical or biological attacks. Just weeks after the events of September 11, two Senate offices and several media outlets were contaminated by anthrax-laced letters that resulted in five fatalities and seventeen persons becoming ill. These events were relatively small in scale and complexity, and as

noted previously in this testimony, a large-scale NBCR event in a densely-populated urban area like Manhattan could result in insured losses of $778 billion.

In September 2006, the Government Accountability Office (GAO) released a report concluding that the NBCR risk does not match the principles of insurability. There is little appetite in the private market to insure it even with the presence of a federal backstop, and even in a non-terrorism context. Private insurers currently structure their policies to exclude NBCR events, except where coverage is expressly required under state law, such as with workers' compensation coverage. However, the potential catastrophic nature of the NBCR risk poses a serious threat to policyholders and our national economy. I encourage you to consider inclusion of terrorist related NBCR losses in any backstop that becomes effective next year. Inclusion of the NBCR risk should be structured so as to leverage the private market's ability to issue policies and settle claims while recognizing the private market's difficulty in overcoming the challenge of insurability. The threshold of retention for NBCR risks should be much lower than for other risks but set at a level to ensure private market participation and responsibility.

Responsibility of Policyholders and Insurers

Some have argued that federal involvement in terrorism insurance has stymied the development of private market solutions and personal responsibility on the part of commercial policyholders. As my predecessor, Howard Mills, stated to this Committee in 2005, in New York State and indeed throughout the country we see little evidence to support this conclusion. To the contrary, the evidence demonstrates that owners have invested heavily in strengthening disaster preparedness and response efforts in the wake of the 9/11 terrorist attacks notwithstanding the existence of a federal backstop.

For example, since 9/11, most large commercial and many multi-family residential buildings in New York and elsewhere regularly subject entrants to security checks before permitting entry. Sensitive locations may even require visitors to submit to background checks prior to entry. Structural design has also changed substantially in response to the

terrorist threat, not the least of which is the ubiquitous use of barriers to thwart vehicle-borne explosive devices.

The country has taken steps to improve airport and aircraft security and to harden many of our commercial enterprises and government facilities, but we still remain vulnerable to another terrorist attack with a potential magnitude that dwarfs the insurance industry's capacity to respond. The steps taken to mitigate losses may also result in countermeasures by terrorist that could lead to attacks on buildings or infrastructure that we might not have previously considered targets. This inescapable reality demonstrates the need for a federal backstop to help in dealing with potential losses of this magnitude. Clearly, loss control must be a part of any long-term solution in the private sector to manage terrorism exposures, but such mitigation techniques do not address the issue of financing the catastrophic losses should they occur. No amount of mitigation can result in foolproof guarantees that losses will not occur. Terrorism coverage in today's world is an integral part of any business's risk management efforts. Without a federal backstop we could face market disruptions, and terrorism insurance will likely become less affordable or even unavailable to consumers.

Conclusion

I strongly urge Congressional action to ensure a sustained and stable marketplace for terrorism insurance by providing a federal backstop program. Such a program should cover foreign and domestic events, expand coverage to group life insurance, and provide a mechanism to leverage the private market strengths in covering NBCR risks. Terrorism insurance is crucial to the healthy functioning of the American economy, and in the absence of private market capacity, federal involvement is essential.

My Office stands readv to assist Congress in developing an appropriate federal terrorism insurance program. Thank you for inviting me to testify and for considering the views of state insurance regulators as you move forward on this crucial issue.

March 5, 2007

Testimony of

Roger W. Ferguson,
Chairman, Swiss R America Holding Corporation
on
"The Need To Extend the Terrorism Risk Insurance Act"

before

The Committee on Financial Services
Subcommittee on
Capital Markets, Insurance, and Government Sponsored Enterprises

U.S. House of Representatives

I would like to thank Chairmen Kanjorski and Frank for holding this hearing on the need to extend the Terrorism Risk Insurance Extension Act, an important and very successful public-private partnership. My name is Roger W. Ferguson. I am chairman of Swiss Re American Holding Corporation, a member of the Executive Committee and Head of Swiss Re Financial Services. Swiss Re, the largest reinsurer in North America and the world, is a member of the American Council of Life Insurers and the Reinsurance Association of America.

TRIEA may be analyzed from many different perspectives. As an economist, I'd like to share a few thoughts about why this public-private partnership is critical to an important segment of the US economy. My argument has three parts. First, terrorism does not have the usual characteristics of an insurable risk. Second, industry capacity is insufficient to handle the losses that would arise from a major terrorist event. And third, the government has created an implicit backstop already. From those three points, I conclude it is better public policy to have an explicit Federal backstop for the terrorism insurance market.

Competitive private markets generally lead to the most productive allocation of resources. Nonetheless, markets sometimes fail to function efficiently, creating a waste of resources and the loss of economic value. Terrorism insurance and reinsurance are businesses prone to market failure because terrorism risk is largely uninsurable for the following reasons:

- First, terrorism risk cannot be measured satisfactorily because terrorist events are willful acts undertaken by parties who wish to confound those who study them. The historical data on these events is scarce and of little relevance in predicting future events. There is no reliable model that measures terrorism risk.

- Second, terrorists' coordinated large-scale attacks can cause loss occurrences to be correlated over time and across business lines. This makes the risk difficult to diversify. The vast loss potential of terrorist events further undermines the private insurance industry's ability to diversify its terrorism risk exposures.

- Finally, due to adverse selection, terrorism insurance may become unaffordable in the major urban areas, where the need for coverage is greatest.

After 9/11 highlighted these dimensions of terrorism risk — its unpredictability, high correlation of loss occurrences and large scale of potential losses — insurers withdrew from the market. In a clear case of market failure, real estate projects, particularly those in target areas such as New

York, were delayed or canceled because insurance could not be secured. This economic domino effect ultimately resulted in the loss of jobs.

Aside from the fact that a terrorist event does not have the usual characteristics of insurability, the potential scale of the risk makes it difficult for the private sector to manage on its own. Although the US property/casualty sector has an aggregate surplus of more than $400 billion and writes nearly $500 billion in annual premiums, it lacks the resources to cover large-scale terror events. Only a small fraction of industry premiums and surplus is available to cover terrorism losses because this money must also be available to repay policyholders for losses due to other insured risks such as workers' compensation, product liability, fires and earthquakes.

We cannot look to Insurance-linked securities (ILS) to provide substantial terrorism risk coverage, at least for the foreseeable future. ILS investors have many of the same concerns about terrorism risk as insurers and reinsurers. Consequently, no pure terrorism bond has yet been issued. The most mature ILS segment, catastrophe bonds and sidecars (a variant on cat bonds), had $10 billion of issuance in 2006, an amount dwarfed by the potential size of insured losses from a large terrorism event.

Many observers believe that the government would be forced to provide aid to individuals, insurers and other businesses who suffer devastating losses from a terrorist event, even if they have not purchased insurance. There is ample precedent to support this belief. Thus, even without an explicit terrorism risk backstop, the government provides an implicit backstop. The absence of an explicit program distorts incentives and increases the likelihood of misspending funds. Confusion about whether the government would step in is clearly not constructive.

An explicit government terrorism risk backstop offers numerous advantages. First, it reduces ambiguity both pre- and post-event and enhances transparency by making it clear who will pay how much for what, should an event occur. This clarity makes it easier for insurers to price risks more fairly and strengthens the incentives to mitigate risks and to purchase terrorism insurance. Second, a broader societal sharing of terrorism risk makes lower premium rates possible. Third, by reducing uncertainty, a backstop reduces the risk of financial market disruption in the wake of an attack.

Finally, I'd like to make a somewhat academic but important point. Please consider for a moment whether an explicit backstop might reduce the "gains to terrorism". A goal of terrorists is to undermine a society through confusion and fear. A major terrorist attack will likely have negative externalities, or spillover effects, on the economy. A government backstop mitigates these losses by: keeping insurers solvent; assuring that insured victims of attacks receive policy benefits promptly; and by preventing a run on insurers and their forced sale of securities. A backstop that provides contingent resources reduces the cost of disruptions and the gains to terrorist acts. Gradually, it may become apparent that terrorist events are less disruptive than attackers had hoped. The prospect of a smaller "payoff" for their activities may conceivably reduce the incentive for terrorists to act.

A viable terrorism insurance market with adequate capacity reduces the level of uncertainty before and after a terrorist attack occurs. Certainty, security, stability and respect for property rights are public services critical to society. This is why governments provide law enforcement and national defense.

In closing, insurers, Swiss Re among them, generally agree that TRIEA has done a good job of stabilizing the terrorism insurance market. There are, however, several elements that undercut the law's benefits.

- First is the distinction between certified acts of terrorism, which TRIEA covers, and non certified acts, which it does not. This distinction creates areas of ambiguity that makes the law's protections less certain and therefore less effective.

- Second is the law's impermanence. Uncertainty regarding whether the backstop will be renewed every two years taxes the energies of lawmakers and insurers, which can better be spent on finding permanent solutions to the challenges that terrorism poses.

- A final point of note is the exclusion of group life from TRIEA's covered lines. Group life business, like worker's compensation, contains a significant concentration of risk. Moreover, group life insurers are not free to manage their risk through terrorism exclusions. Most state regulators do not allow it. A very large scale attack can cause a massive number of mortality claims that threatens the stability of even the leading group life insurers. In view of this, group life should be part of an effective Federal backstop. Group life insurers have asked that a separate recoupment mechanisms be created for group life insurers. This seems logical and reasonable.

The US is not alone in providing a government backstop. Many other countries have government-backed terrorism insurance programs. To help meet the threat that terrorism poses in a proactive, economically efficient manner, we ask this Subcommittee to craft a permanent public-private response that builds on the strengths of the insurance industry and of the government.

Thank you for the opportunity to express our views on this very important matter.

MORTGAGE BANKERS ASSOCIATION
Investing in communities

**Statement of Steven K. Graves,
Managing Director and Chief Operating Officer for
Principal Real Estate Investors and
Vice Chair of the Commercial Real Estate/Multifamily
Finance Board of Governors,
Mortgage Bankers Association**

**Before the
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives**

Hearing on

The Need to Extend the Terrorism Risk Insurance Act

March 5, 2007

City Hall, New York

Introduction
Good Morning. My name is Steven K. Graves and I am Managing Director and Chief Operating Officer for Principal Real Estate Investors, the dedicated real estate group for Principal Global Investors. I also serve as Vice Chair of the Commercial Real Estate/Multifamily Finance Board of Governors of the Mortgage Bankers Association (MBA).[1]

Principal Real Estate Investors is one of the nation's largest commercial real estate lenders with $22 billion in mortgages under management and administration. Consequently, my organization is a major stakeholder the future of the Terrorism Risk Insurance Extension Act of 2005 (TRIEA). In fact, because of TRIEA, I am pleased to report that terrorism insurance is in place for over 90 percent of the commercial real estate mortgages that my company administers. However, with the expiration of TRIEA looming at the end of this year, Congress must take action to implement a long-term terrorism insurance solution.

The objective of my presentation today will be to provide you with a window into the commercial real estate finance sector that highlights the important role terrorism insurance plays for both the origination of new loans (originations) and the ongoing servicing of existing loans (servicing) and the severe challenges faced by our industry when there is a lack of available and affordable terrorism insurance. In addition, I will discuss the elements of a long-term terrorism insurance solution that MBA is advocating.

TRIEA Has Worked
From the perspective of the commercial real estate finance industry, TRIEA has been an unqualified success for increasing the availability and affordability of terrorism insurance. In fact, a study performed by MBA in 2004 revealed that 84 percent of the surveyed commercial real estate debt outstanding had terrorism insurance in place. The study collected information on more than $656 billion in outstanding commercial and multifamily loans, representing (at the time) 32 percent of the total commercial/multifamily mortgage market. I have attached this study as part of my testimony. The average loan size in the survey was just over $5 million. The survey also revealed that there were nominal differences (1 percent) in the average loan size of all loans in the survey (both loans with and without terrorism insurance) and the average

[1] The Mortgage Bankers Association's (MBA) commercial/multifamily real estate finance division represents over 725 companies operating across the U.S. and internationally. As the premier organization, representing more than $2.845 trillion in mortgage debt outstanding and $345 billion in annual originations, we represent the entire commercial/multifamily mortgage market including: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the commercial/multifamily mortgage lending field. MBA's commercial/multifamily division promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees. It provides industry research, advocacy outreach, networking opportunities to help its members speak to peers, a variety of publications, professional development and education, and overall assistance to its members to help them run their business more effectively and strategically. For additional information, visit the commercial/multifamily real estate finance page on MBA's Web site: www.mortgagebankers.org/cref.

loan with terrorism insurance in place. This counters the popular belief that terrorism coverage is only necessary for high valued "trophy properties" located in high-profile markets.

The chief factor behind the success of TRIEA is the "make available" provision. The "make available" provision in the Terrorism Risk Insurance Act of 2002 (TRIA) and TRIEA requires insurers to offer terrorism coverage for insurance lines eligible to participate in the federal terrorism reinsurance program. Also within the MBA study, respondents estimated that if insurance companies were not mandated to provide terrorism insurance, approximately 80 percent of that $656 billion in debt in the study would not have had terrorism coverage. In fact, most currently available terrorism risk insurance policies are directly conditioned to the TRIEA "make available" provisions. Thus, if the "make available" provision was excluded from a long-term or permanent terrorism insurance solution, a wide range of borrowers and commercial real estate loan servicers would be caught between their contractual obligations to have terrorism insurance in place and a lack of available terrorism insurance.. Accordingly, MBA strongly encourages Congress when contemplating a long-term terrorism insurance solution to include a "make available" provision.

Commercial/Multifamily Real Estate Finance Sector is Vital to the U.S. Economy
With $2.845 trillion in debt outstanding, the commercial/multifamily real estate debt sector is an integral and large part of the national economy. This debt finances the vast majority of office, retail, industrial and multifamily buildings. These buildings house the businesses that are the engines for the nation's vibrant and diverse economy. A lack of available and affordable terrorism insurance, would not only impact the commercial real estate finance sector, but would ripple through the economy as buildings became more difficult and costly to finance and purchase. Consequently, available and affordable terrorism insurance is not only linked to the vitality of the commercial real estate finance sector, it is also a key element in the strategy for reducing the nation's vulnerability to the impacts of a terrorist attack.

T rrorism Insurance is Important to the Commercial/Multifamily Finance Sector
The availability and affordability of terrorism insurance affects the commercial/multifamily real estate finance industry in two fundamental ways; it affects the more than $345 billion in annual originations the industry processes and it also affects the $2.845 trillion in commercial/multifamily mortgage debt outstanding.[2] Originations are comprised of loans that fund new commercial/multifamily projects and refinance existing commercial/multifamily projects.

When terrorism insurance coverage was not available for new projects in the aftermath of September 11th, many new construction projects were delayed and/or cancelled. The negative impact of these delays and cancellations on the national economy were rightfully spotlighted by the media. However, this lack of available and affordable

[2] For originations, the latest MBA survey, *2005 Commercial Real Estate/Multifamily Finance: Annual Origination Volume Summation*, indicated that the top 125 commercial/multifamily finance firms originated $345 billion of commercial/multifamily loans during 2005.

terrorism insurance does not only impact originations, it also has a major impact on the existing $2.845 trillion in outstanding commercial/multifamily debt. Consequently, both areas will be addressed in my statement.

Typical commercial mortgages are made on an 80 percent loan-to-value (LTV) ratio, which means that at the time of loan origination 80 percent of the property value is reflected in the mortgage held by the lender and the remaining 20 percent is owner's equity. Commercial real estate lending is typically non-recourse, meaning that in the case of a mortgage default the lender can only look to the underlying value of the property to recover its mortgage balance, not the assets of the owner. Because most commercial real estate lending is non-recourse, lenders have an acute interest in preserving and protecting asset value. In order to protect their interest in their commercial real estate assets, lenders place paramount importance on requiring and verifying that uninterrupted insurance coverage, including terrorism insurance, is in place for the life of the loan.

The commercial/multifamily side of the mortgage industry includes transactions made by commercial banks, life insurance companies and individual and institutional investors through commercial mortgage-backed securities (CMBS). CMBS are comprised of commercial/multifamily mortgages that are pooled together and sold off in the form of securities, similar to how residential mortgages are securitized. Currently, 20.5 percent of all commercial mortgage debt is in the form of CMBS. Over the past several years, CMBS and commercial mortgage loans have outperformed other asset classes, such as corporate bonds. These investments, therefore, are a part of chief investment officers' permanent allocations and the retirement accounts and/or pensions of many people on fixed incomes. As was demonstrated after the September 11th attacks, a lack of terrorism insurance can lead to rating agency downgrades of CMBS. Such downgrades have the potential to negatively impact the performance of a wide variety of mutual funds that include CMBS in their portfolios.

When commercial insurance carriers excluded terrorism insurance coverage prior to the enactment of TRIA, the risk of a catastrophic terrorism loss shifted from the insurance industry to the commercial real estate finance industry. For this reason, lenders and loan servicers who bear a fiduciary responsibility to investors and funding sources have the greatest standing among all industries in assuring broad availability and affordability of terrorism insurance. Commercial real estate lenders and their servicing firms will experience serious operational difficulties with regard to their existing portfolios if a terrorism insurance solution is not created before TRIEA expires. As the trade association representing the largest concentration of commercial/multifamily lenders and servicers, MBA is uniquely positioned to represent the full breadth and depth of the commercial/multifamily finance industry.

Commercial real estate lenders have underwriting requirements that mandate terrorism insurance be in place as a condition for funding the loan. Should terrorism insurance become unavailable due to the sunset of TRIEA, lenders would be faced with the decision of violating their underwriting requirements or no longer funding loans. The

large scale cancellation of new construction projects and funding of new loans in the aftermath of September 11th strongly indicates that lenders in the absence of available and affordable terrorism insurance would dramatically curtail their lending activity, which would negatively impact new commercial real estate construction.

Role of the Servicer
For the $2.845 trillion in commercial mortgage debt outstanding, the servicer plays a vital role. The role of the commercial/multifamily loan servicer commences the day the loan is closed and ends when the loan is paid off. Between these events, the servicer is responsible for activities such as collecting and dispersing loan payments, administering escrow and reserve accounts, preparing financial reports, monitoring and inspecting collateral, transferring ownership and default administration. Collectively, these responsibilities ensure that the underlying collateral is being properly maintained and the cash flow from mortgage payments is being properly disbursed.

Servicers bear the fiduciary responsibility, as described in transaction legal documents, of ensuring that required insurance coverage, including terrorism insurance coverage, is in place during the life of the loan. Servicers are required to verify adequate insurance is in place on an annual basis, not just at the inception of a loan.

In the case of terrorism insurance coverage, there is significant risk for servicers not to be able to meet their fiduciary responsibility to verify that terrorism coverage is in place on an annual basis. In the aftermath of September 11th, insurers dropped terrorism insurance coverage and did not notify lenders or servicers when new annual insurance contracts were issued. This lack of notification or transparency placed a huge liability on lenders, who are listed on insurance contracts as co-payees or additional insured. This left servicers with the responsibility of having to review every insurance contract for each loan to verify that terrorism coverage was in place. This process was greatly complicated by not having a transparent process in place for insurance companies to notify servicers and lenders that terrorism coverage was in place. MBA seeks to preserve notifications to all policy insureds during the life of the loan, which is critical to effectuating information transparency and protection to property owners, lenders and investors.

Long-Term Terrorism Insurance Solution
MBA will be evaluating specific long-term terrorism solution proposals based on a set of principles that will ensure adequate insurance for terrorism, as required by commercial real estate finance lenders and servicers. MBA will examine each long-term terrorism insurance proposal based on it meeting the following principles:

- **Widely Available** - Terrorism insurance needs to be widely available, which would require the existing "make available" provision in Terrorism Risk Insurance Extension Act of 2005 (TRIEA) be included in a long-term terrorism insurance solution.

- **No Interruptions** - The long-term terrorism insurance solution should be crafted in a manner that eliminates short-term interruptions in terrorism insurance availability or price shocks when it is implemented.

- **Affordable** - Terrorism insurance needs to be priced in an affordable manner.

- **All-Peril Coverage** – Terrorism insurance will cover all-perils including nuclear, biological, chemical, and radiological threats.

- **All Terrorism Sources** – Terrorism insurance should cover both foreign and domestic source terrorist events.

- **Lender/Servicer Notifications** - Lenders/servicers are listed as mortgagee, loss payee and additional insured depending on the loan documentation and as such they are entitled to specific notifications of coverage lapses, gaps, and renewals. Any long-term solution needs to preserve and implement the required notification.

N ed for a Public/Private Partnership
The MBA, along with the Coalition to Insure Against Terrorism (CIAT), has been participating in efforts to bring greater consensus regarding a long-term terrorism insurance solution. In one area, there is widespread consensus is the need for a public/private partnership in the case of a catastrophic terrorist event. At the March 29, 2006, National Association of Insurance Commissioners (NAIC) Public Hearing on terrorism insurance, insurance companies and insurance company trade associations testified that without a federal backstop the insurance industry would pull out of the terrorism insurance business in mass because of the inability of the insurance industry to accurately model terrorism risk.

In its analysis of terrorism events, the American Academy of Actuaries (AAA) stated the following: "Because of the potential for terrorist attacks that could cause very large losses, the Subgroup [Terrorism Risk Insurance Subgroup] does not believe there is any strategy that can develop sufficient terrorism insurance capacity without some form of legislation that limits insurer liability should these events occur." Given the statement of the AAA and the insurance companies, we believe that any long-term terrorism insurance solution will need to include a public/private partnership that will allow insurance companies to quantify their potential exposure to a terrorist event.

In 2006, MBA participated in meetings with both the President's Working Group on Financial Markets (PWG) and Government Accountability Office (GAO) to discuss availability and affordability issues associated with nuclear, biological, chemical, and radiological (NBCR) terrorism risk insurance. The reports released by the both PWG and GAO concluded that the private sector does not have sufficient capacity to offer NBCR terrorism risk insurance. Consequently, any long-term terrorism solution should address this serious private sector insurance coverage gap. In order to make NBCR

coverage widely available, a long-term terrorism risk insurance solution would also need to include NBCR events in the "make available" provision. Given the extreme insurance loss potential from an NBCR event, policy makers, when contemplating a long-term terrorism insurance solution, should consider lower co-pays and deductibles for NBCR events for insurance companies.[3] This will allow NBCR insurance coverage to be made available at commercially affordable pricing.

Conclusion

Once again, I appreciate the opportunity to provide our perspective on terrorism insurance to the Subcommittee. As the nation's largest representative of commercial real estate mortgage lenders and servicers, MBA stands ready to provide any assistance that the Subcommittee, full committee or Congress may require. We look forward to the opportunity of partnering with the Congress and the appropriate government agencies and the insurance industry to help craft a long-term solution for terrorism insurance that makes terrorism insurance coverage inclusive, available and affordable. Thank you very much for your attention on this vital matter.

[3] According to the study released on March 29, 2006 by the American Academy of Actuaries, a large NBCR event in New York City could result in $778.1 billion in losses, which is greater than the insurance industry's aggregate policy holder's surplus, which would be used to pay for such an event.

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STUDY OF TERRORISM INSURANCE, TRIA AND THE "MAKE-AVAILABLE" PROVISION

June 2, 2004

Background

President George W. Bush signed the Terrorism Risk Insurance Act of 2002 (TRIA) into law in November 2002. Section 103(c) of the act requires commercial property and casualty (P&C) insurers to make available coverage for insured losses that does not differ materially from the terms applicable to insured losses arising from events other than terrorism. This section of TRIA also requires that the Treasury Secretary determine no later than Sept. 1, 2004, whether to extend the "make-available" requirements through the calendar year 2005. In arriving at this decision, the Secretary must consider:

a. TRIA's effectiveness;
b. the likely capacity of the P&C insurance industry to offer terrorism insurance after termination of the federal reinsurance program authorized under TRIA; and
c. the availability and affordability of such insurance.

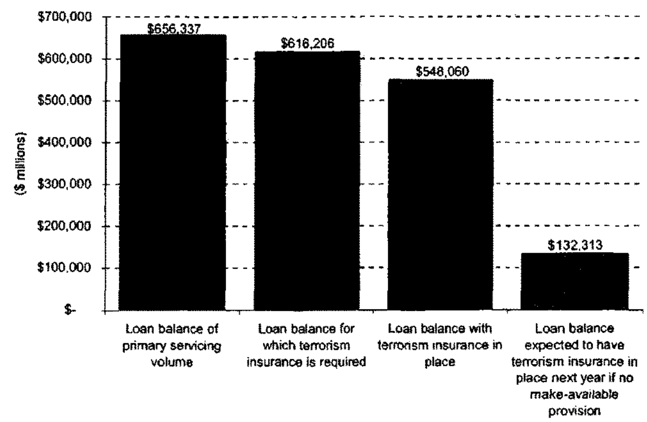
In May 2004, the Mortgage Bankers Association (MBA) conducted a study, in response to a request by the U.S. Treasury Department, to gather urgently needed information on the effectiveness of TRIA. The study looked at commercial and multifamily mortgages being serviced by the nation's top servicers, and collected information on the requirements for and prevalence of terrorism insurance coverage, as well as the implications if make-available requirements were removed.

Findings

Terrorism insurance has become integral to the $2 trillion[1] commercial/ multifamily mortgage market. Of the $656 billion of commercial/multifamily debt reviewed in the MBA study, $616 billion, or 93.9 percent, is required to have terrorism insurance by the mortgage investor and/or servicer. A full $548 billion, or 83.5 percent of the outstanding balance of the commercial/multifamily debt reviewed, had terrorism insurance in place.[2]

Reinforcing the finding that terrorism insurance is widely required and widely in place, the average loan size of the 122,811 loans in the analysis was $5.34 million. The average loan size requiring terrorism insurance coverage was only slightly higher at $5.4 million, as was the average loan size with terrorism insurance in place – $5.53 million.

Figure 1. The Role of Terrorism Insurance in the Commercial/Multifamily Mortgage Market ($ millions)



Insurance specialists at every servicer involved in the study expect that, if the make-available provision is not extended, terrorism endorsements that are currently in place will be cancelled or excluded[3]. They estimate that absent make-available, by the spring of 2005 only 20 percent, or $132 billion, of their collective portfolios would have terrorism coverage in place. This represents a reduction of 76 percent – or $416 billion – in the balance of loans that would be covered for losses from terrorism.

[1] Estimate of total market size from Federal Reserve Board's *Flow of Funds Report*, March 4, 2004

[2] The 10 percent of commercial/multifamily debt for which terrorism insurance is required but not in place includes properties for which the servicer and borrower are working to place coverage, properties for which the requirements have been waived and some properties that may have "all-risk" coverage that has been deemed to include terrorism coverage, but for which an explicit statement of terrorism coverage does not exist.

[3] Cancelled policies represent those cases where a borrower's existing insurance policy is terminated. Excluded policies represent cases where the existing policy would remain in place, but the coverage afforded terrorist acts would be excluded.

The market implications of such reductions would be declines in market liquidity, increased costs and reduced availability of credit, and a subsequent fall in the yield on existing loans.

Terrorism Insurance Requirements by Investor Type

One of the strengths of the commercial/multifamily mortgage market is the degree to which risks associated with the timely repayment of principal and interest are divided and shared across different market participants. Whether through tranching[4] of commercial mortgage backed securities (CMBS), shared risk on loans by government-sponsored enterprises (GSEs) or other mechanisms, there are often many participants with "skin in the game" – that is, participants taking on the risks associated with timely repayment.

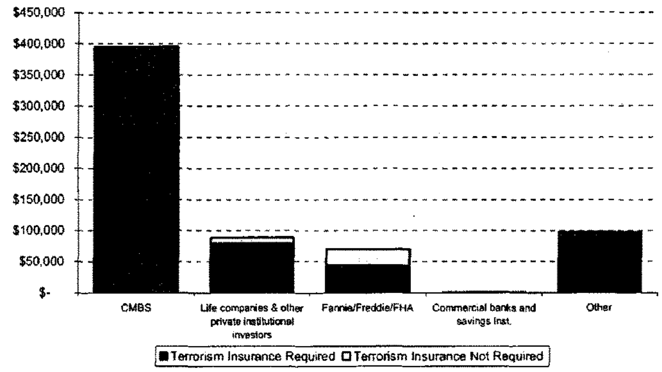
To protect their interests in the mortgage debt, participants, through their loan servicers, require insurance for fire, wind, flood and other hazards. Prior to Sept. 11, 2001, property insurance policies insured against terrorism losses by virtue of such losses not being excluded from the "all-risk" policy forms required by the lenders and investors. After Sept. 11, 2001, when virtually all insurers amended their policy forms to exclude terrorism coverage, lenders and investors explicitly required terrorism coverage to be obtained.

In the portfolios studied, 100 percent of the balance being serviced for CMBS and warehouse and other affiliates were required to have terrorism insurance in place. Eighty-nine (89) percent of the balance serviced for life companies was required to have terrorism insurance in place, as was 68 percent of the Fannie Mae and Freddie Mac balance and 43 percent of the Federal Housing Administration (FHA) and Ginnie Mae balance. Twenty-eight (28) percent of the balance serviced for commercial banks and savings and loans required terrorism insurance[5].

[4] CMBS are typically divided into classes or tranches, which carry different risk profiles and coupons (or returns). CMBS offers investors an opportunity to purchase the tranche that best fits their risk profile.

[5] Commercial banks and savings institutions are only minimally represented in this analysis. The best insights into their requirements for terrorism insurance come from the first quarter 2002 Federal Reserve Board of Governors' *Senior Loan Officer Opinion Survey on Bank Lending Practices*. That study found three-quarters of the 51 banks responding (74.5 percent) required terrorism insurance on 10 percent or less of their loan balance on high-profile/heavy-traffic properties. Eighty-two percent also required terrorism insurance on 10 percent or less of their loan balances on properties that are not high-profile/heavy-traffic properties. The Fed noted, however, that the six banks reporting the tightest terrorism insurance requirements represented 8 percent of all commercial real estate debt.
(See http://www.federalreserve.gov/boarddocs/snloansurvey/200205/default.htm.)

Figure 2. Commercial/Multifamily Loan Balance Requiring Terrorism Insurance, by Investor Group ($ millions)



Ensuring Terrorism Insurance Coverage

As noted here, there are times in the current make-available environment when terrorism insurance coverage is required, but is not in place (see note 2). In these cases, the servicer has the responsibility to ensure that coverage is put in place, thereby protecting the collateral underlying the mortgage loan. To do this, servicers most often rely on working directly with the borrower to put coverage in place.

Eighty-three percent of the servicing firms involved in the MBA study said they expect to always/almost always "notify the borrower of requirements and work with him/her to purchase" the necessary coverage when adequate coverage is not in place. Twenty-eight percent expect to always/almost always "force-place" coverage – wherein the servicer purchases the coverage and bills the borrower for its cost; 44 percent expect to seldom use this approach. More than half (56 percent) expect to seldom "declare an event of default[6]," with another one-third (33 percent) expecting to never/almost never declare default to ensure adequate coverage. "Litigation to require borrower to purchase coverage" is a little-used approach in resolving a lack of coverage, with no servicers expecting to always/almost always use this approach and two-thirds (67 percent) expecting to never/almost never use this approach.

With the absence of a make-available provision, however, these dynamics would change. Faced with an environment in which 75 percent of current coverage would be expected to be lost, servicers see their options for ensuring adequate coverage as limited.

In the absence of a make-available provision, the most frequently used current course of resolution – "notify the borrower of requirements and work with him/her to purchase" – is expected to be "very successful" by only 17 percent of the servicers, "somewhat

[6] A default is a breach or nonperformance of any of the terms or covenants of the loan documents, and can trigger a variety of actions, including foreclosure.

successful" by 67 percent and "not at all successful" by 17 percent. The resulting high costs and low availability would greatly hamper the success of this resolution.

At present, force-place coverage is the second most popular resolution. Without make-available, however, force-place would be expected to be "very successful" by only 17 percent of the servicers, "somewhat successful" by 56 percent and "not at all successful" by 28 percent. Prior to TRIA, such force-place policies were neither affordable nor available.

Litigation is seen as potentially "somewhat successful" to more than half of the respondents (54 percent). At present, litigation is a little-favored means of gaining coverage, largely because affordable coverage can be obtained through other means. If the make-available provision is not extended, however, the low success rate of other resolutions can be expected to increase the use of litigation as the vehicle to ensure coverage.

The Role of TRIA

TRIA is essential to making terrorism insurance available and affordable, and in helping keep the commercial/multifamily mortgage market healthy. Every one of the servicers managing the $656 billion of commercial/multifamily loans studied here responded that:

- the federal government's requirement that insurance carriers make available terrorism insurance helped increase the <u>availability</u> of terrorism insurance.

- the federal government's requirement that insurance carriers make available terrorism insurance helped bring the <u>price</u> of terrorism insurance within reach.

- the <u>continuation</u> of the federal government's requirement that insurance carriers make-available terrorism insurance is necessary to ensure the continued <u>availability</u> of terrorism insurance.

- the <u>continuation</u> of the Federal government's requirement that insurance carriers make-available terrorism insurance is necessary to ensure terrorism insurance continues to be <u>priced</u> within reach.

- the <u>federal government should continue the TRIA make-available requirement</u> throughout 2005.

All servicers but one stated that the federal government's requirement that insurance carriers make-available terrorism insurance is <u>necessary to ensure a healthy market</u> for commercial real estate loans.

Costs of Managing Terrorism Insurance Coverage

Extension of TRIA and the make-available provision also has an administrative impact on commercial/multifamily mortgage servicers. A full 94 percent of responding commercial/multifamily servicers expect expenses to rise if the make-available provision is not extended. Fifty-nine percent of servicers expect a significant increase in expenses – in terms of additional staffing, costs of litigation, etc. An additional 35 percent expect a moderate increase in expenses and 6 percent indicated no change in expenses. As costs

associated with managing commercial mortgage portfolios increase, the yield, or return, on those portfolios would drop. Such changes would clearly have implications for market value and liquidity.

The Study

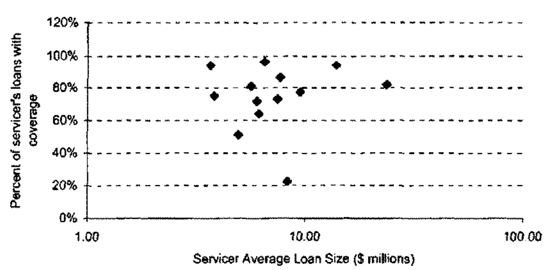
The MBA Study of Terrorism Insurance, TRIA and Make-Available collected information on more than $656 billion in outstanding commercial and multifamily loans – or 32 percent of the total commercial/multifamily mortgage market. The study includes representation across most major investor classes, including CMBS, life companies, Fannie Mae, Freddie Mac, FHA and others. Two major investor groups were only minimally represented – commercial banks and savings and loans. The study includes information from all 10 of the top 10 servicers, as well as 14 of the top 20 and 18 of the top 50 commercial/multifamily mortgage servicers.

Not all servicers were able to provide loan balance information. The dollar figures presented here represent the $656 billion for which loan balance information was available. The attitudinal responses are for all 18 responding servicers.

The study included aggregate reporting by large commercial/multifamily loan servicers on their portfolios as of the most recent reporting period available – generally either March or April 2004.

The study covered 122,811 commercial/multifamily loans. The average loan size covered by the study is $5.34 million. As evidenced in Figure 3, while there is a wide range in the average loan size and percentage of the servicing portfolio covered by terrorism insurance by servicer, there does not appear to be any relationship between the average loan size of a servicer and the percentage of that servicer's portfolio with terrorism insurance coverage.

Figure 3. Relationship Between Servicer's Average Loan Size and the Percentage of Loans with Terrorism Insurance Coverage ($ millions)



MORTGAGE BANKERS ASSOCIATION
Investing in communities

The Mortgage Bankers Association

The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 400,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of approximately 2,700 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

MBA SURVEY ON TERRORISM INSURANCE, TRIA AND MAKE AVAILABLE, MAY 2004

MORTGAGE BANKERS ASSOCIATION

Please provide data on the servicing portfolio for which you are the PRIMARY servicer
Contact Jamie Woodwell of the MBA at 202-557-2936 with any questions.
eMail completed survey to jwoodwell@mortgagebankers.org or fax to 202-721-0245 BY MAY 19, 2004

Firm Name: __________

Name of Survey Contact: __________

Phone Number: __________

eMail Address: __________

Data is "as of" (place an "X" in the appropriate box): April 30, 2004 [ ] *If April data is not available* March 31, 2004 [ ]

1. What is the size of the portfolio for which you are the PRIMARY servicer?	Number of loans	Loan Balance ($millions)
A. Total primary servicing volume	122,811	$ 656,337
B. Primary portfolio for which terrorism insurance is required	114,171	$ 616,206
C. Primary portfolio with terrorism insurance in place	99,106	$ 548,060

D. If the "make available" provision of TRIA is not extended, what ***percent*** of your portfolio would you expect to have terrorism insurance in place next year at this time. 20%

2. Please provide the following information on the REQUIREMENTS FOR TERRORISM INSURANCE that are imposed either by your own company or by the lenders for whom you service.

Portfolio	**Require Terrorism Insurance (Y/N)**	Current Unpaid **Principal Balance** of loans requiring terrorism insurance ($millions)	Current Unpaid **Principal Balance** of loans NOT requiring terrorism insurance ($millions)	Comments/Description of Requirements (Feel free to add additional comments in the box for Question 13)	Percent Requiring
CMBS		$ 394,973.02	$ 110.31		100.0%
Life Companies & Other Private Institutional Investors		$ 79,566.12	$ 9,769.24		89.1%
Fannie Mae/Freddie Mac		$ 37,037.65	$ 17,103.43		68.4%
FHA & Ginnie Mae		$ 7,160.19	$ 9,466.75		43.1%
Commercial Banks and Savings Inst.		$ 367.80	$ 940.00		28.1%
Warehouse & Other Affiliate Cos		$ 18,670.59	$ -		100.0%
Others		$ 77,866.81	$ 1,407.00		98.2%

3. When a borrower does not have adequate coverage, what share of the time would you expect to use each of the following alternatives? (Place an "X" in ONE box for each alternative)

A. Force Place coverage

Always/Almost Always	5	28%
Often	2	11%
Seldom	8	44%
Never/Almost Never	3	17%

B. Litigation to require borrower to purchase coverage

Always/Almost Always	0	0%
Often	0	0%
Seldom	6	33%
Never/Almost Never	12	67%

C. Declare an event of default

Always/Almost Always	1	6%
Often	1	6%
Seldom	10	56%
Never/Almost Never	6	33%

D. Notify borrower of requirement & work with him/her to purchase

Always/Almost Always	15	83%
Often	2	11%
Seldom	1	6%
Never/Almost Never	0	0%

E. Other: ________________

Always/Almost Always	1	20%
Often	3	60%
Seldom	1	20%
Never/Almost Never	0	0%

4. If the Federal government's requirement that insurance carriers "make available" terrorism insurance is <u>not extended</u>, how successful would you expect each of the following to be in assuring coverage for inadequately covered properties? (Place an "X" in ONE box for each alternative)

A. Force Place coverage

Very successful	3	17%
Somewhat successful	10	56%
Not at all successful	5	28%

B. Litigation to require borrower to purchase coverage

Very successful	0	0%
Somewhat successful	10	56%
Not at all successful	8	44%

C. Declare an event of default

Very successful	0	0%
Somewhat successful	8	44%
Not at all successful	10	56%

D. Notify borrower of requirement & work with him/her to purchase

Very successful	3	17%
Somewhat successful	12	67%
Not at all successful	3	17%

E. Other ________________

Very successful	1	25%
Somewhat successful	2	50%
Not at all successful	1	25%

5. Do you expect terrorism endorsements to be cancelled or excluded if the "make available" provision is not extended? (Place an "X" in the appropriate box)

Yes [18] No [0]

6. Has the Federal government's requirement that insurance carriers "make available" terrorism insurance helped increase the <u>availability</u> of terrorism insurance? (Place an "X" in the appropriate box)

Yes [18] No [0]

7. Has the Federal government's requirement that insurance carriers "make available" terrorism insurance helped bring the <u>price</u> of terrorism insurance within reach? (Place an "X" in the appropriate box)

Yes [18] No [0]

8. Is the <u>continuation</u> of the Federal government's requirement that insurance carriers "make available" terrorism insurance necessary to ensure the continued <u>availability</u> of terrorism insurance? (Place an "X" in the appropriate box)

Yes [18] No [0]

9. Is the <u>continuation</u> of the Federal government's requirement that insurance carriers "make available" terrorism insurance necessary to ensure terrorism insurance continues to be <u>priced within reach</u>? (Place an "X" in the appropriate box)

Yes [18] No [0]

10. Is the Federal government's requirement that insurance carriers "make available" terrorism insurance necessary to ensure a healthy market for commercial real estate loans? (Place an "X" in the appropriate box)

Yes [17] No [1]

11. Should the Federal government continue the TRIA "make available" requirement throughout 2005? (Place an "X" in the appropriate box)

Yes [18] No [0]

12. What would you expect to be the impact on your company's expenses -- in terms of additional staffing, costs of litigation , etc -- if "make available" is not extended? (Place an "X" in the appropriate box)

Significant increase in expenses	10	59%
Moderate increase in expenses	6	35%
No change in expenses	1	6%
Moderate decrease in expenses	0	0%
Significant decrease in expenses	0	0%

CIAT COALITION TO INSURE AGAINST TERRORISM
insure against terrorism.org

American Bankers Association
American Bankers Insurance Association
American Gas Association
American Hotel and Lodging Association
American Public Power Association
American Resort Development Association Resort Owners' Coalition
American Society of Association Executives
America's Community Bankers
Associated Builders and Contractors
Associated General Contractors of America
Association of American Railroads
Association of Art Museum Directors
The Bond Market Association
Building Owners and Managers Association International
Boston Properties
CCIM Institute
Chemical Producers and Distributors Association
Commercial Mortgage Securities Association
Edison Electric Institute
Electric Power Supply Association
The Food Marketing Institute
General Aviation Manufacturers Association
Helicopter Association International
Hilton Hotels Corporation
Host Marriott
Independent Electrical Contractors
Institute of Real Estate Management
International Council of Shopping Centers
The Long Island Import Export Association
Marriott International
Mortgage Bankers Association of America
National Apartment Association
National Association of Home Builders
National Association of Industrial and Office Properties
National Association of Manufacturers
National Association of REALTORS®
National Association of Real Estate Investment Trusts
National Association of Waterfront Employers
National Association of Wholesaler-Distributors
National Basketball Association
National Collegiate Athletic Association
National Council of Chain Restaurants
National Football League
National Hockey League
National Multi Housing Council
National Petrochemical & Refiners Association
National Restaurant Association
National Retail Federation
National Roofing Contractors Association
National Rural Electric Cooperative Association
The New England Council
New York City Partnership
Office of the Commissioner of Baseball
Public Utilities Risk Management Association
The Real Estate Board of New York
The Real Estate Roundtable
Six Continents Hotels
Society of American Florists
Starwood Hotels and Resorts
Taxicab, Limousine & Paratransit Association
Travel Business Round Table
UJA-Federation of New York
Union Pacific Corporation
U S Chamber of CommerceWestfield

STATEMENT

OF

STEPHEN L. GREEN

CHAIRMAN, SL GREEN REALTY CORPORATION

ON BEHALF OF

THE COALITION TO INSURE AGAINST TERRORISM

BEFORE A HEARING OF

THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OF

THE HOUSE COMMITTEE ON FINANCIAL SERVICES

IN NEW YORK CITY

REGARDING

THE NEED TO EXTEND THE TERRORISM RISK INSURANCE ACT

MARCH 5, 2007

♦ ♦ ♦

1875 Eye Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401

Good morning, Chairman Kankjorski, Ranking Member Pryce, and Members of the Subcommittee. Thank you very much for holding this hearing in New York and for allowing me to testify today. My name is Stephen L. Green, and I am the Chairman of the Board of Directors of SL Green Realty Corporation - the largest owner of commercial office properties in New York City - the nation's largest office market.

I also serve as a Governor of the Real Estate Board of New York and I am a member of The Real Estate Roundtable and the National Association of Real Estate Investment Trusts (NAREIT). I am testifying today on behalf of the Coalition to Insure Against Terrorism (CIAT).

CIAT is a broad coalition of commercial insurance consumers formed immediately after 9/11 to ensure that American businesses could obtain comprehensive and affordable terrorism insurance. CIAT joined Congress and the Administration in recognizing that only the Federal government could provide the framework to make this coverage available to all those who required it. The diverse CIAT membership represents virtually every sector of the U.S. economy: hotels, banking, energy, construction, entertainment, real estate, stadium owners, manufacturing, transportation, as well as public sector buyers of insurance. For example, the U.S. Chamber of Commerce, the Real Estate Roundtable, the National Association of Manufacturers, and the National Retail Federation are members. So are, to name a few sectors, transportation interests (e.g., the Association of American Railroads, the General Aviation Manufacturers Association, and the Taxicab, Limousine and Paratransit Association), utilities (e.g., American Gas Association, American Public Power Association, Edison Electric Institute, and National Rural Electric Cooperative Association), finance (e.g., American Bankers Association, America's Community Bankers, Mortgage Bankers Association of America, Commercial Mortgage-Backed Securities Association), real estate (American Resort Development Association, National Association of Realtors, Building Owners and Manufacturers International, International Council of Shopping Centers, and National Association of Industrial and Office Properties) and sports (e.g., Major League Baseball, NFL, NBA, NHL, and the NCAA).

CIAT is the true consumer voice on terrorism risk insurance, as we are comprised of the principal policyholders of commercial property and casualty lines of insurance in the United States. From this perspective we offer our testimony today.

We are gratified that Chairman Kanjorski and Ranking Member Pryce have so clearly made this issue a priority today – as both of you have in the past – by scheduling this hearing as one of the Subcommittee's first items of business in the year. As we have seen before in 2005 when the Terrorism Risk Insurance Act (TRIA) was set to expire, problems associated with the availability of terrorism risk insurance will increasingly get worse as the year wears on.

Frankly, we believe there is no need for delay in action by Congress. The facts are in – terrorism is clearly a risk that the private insurance industry alone can not and will not underwrite. The means and courses of future attacks are unknown, but we do know that the potential for loss in such an attack or in a series of such attacks is exceedingly large, potentially catastrophic.

Moreover, the Government Accountability Office (GAO) and the President's Working Group on Capital Markets (PWG) have recently issued reports that confirm that, other than for workers' compensation insurance mandated by state law, no meaningful amount of insurance against loss from weapons of mass destruction (nuclear, biological, chemical and radiological or "NBCR") is available in the market today – notwithstanding the fact that TRIA backstops such insurance.

To avert disruption in the "conventional" terrorism risk insurance market and to address the gap in coverage against NBCR terrorism-related risk, we encourage this Subcommittee to follow this hearing promptly with the introduction and passage of a bill that will extend TRIA permanently and improve it to keep the economy running smoothly in the face of the ongoing threat of terrorist attacks.

TRIA HAS BEEN A POST-9/11 SUCCESS BUT MUST BE IMPROVED

There is no question that the Terrorism Risk Insurance Act (TRIA) accomplished its main objectives, which were to help stabilize the US economy following 9/11, to provide for the availability of terrorism insurance for commercial policyholders in the face of the ongoing threat of terrorism, and to also provide a system for the efficient recovery of the economy in the case of another severe attack. The situation was dire: in the 14-month period between 9/11 and the enactment of TRIA – over $15 billion in real estate related transactions were stalled or even cancelled because of a lack of terrorism insurance, according to a Real Estate Roundtable study. Furthermore, the White House Council of Economic Advisors indicated that approximately 300,000 jobs were lost over that period. Congress and the President worked together to enact TRIA, which required insurers to make terrorism coverage available in commercial lines, and in return provided a Federal backstop that allows the economy to recover quickly from a terrorist attack. Without it, not only was the economy slowed and at risk, but economic recovery following any further attack would have been retarded. The same is still true today.

TRIA, and its extension in 2005, the Terrorism Risk Insurance Extension Act (TRIEA), were part of a series of measures Congress passed to protect the US economy from terrorism threats, and continues today to be an integral part of our homeland security strategy. For instance, U.S. airlines are <u>directly</u> insured by the Department of Transportation (DOT) for both terrorism and war risk. The Federal Government, through the Overseas Private Investment Corporation (OPIC), also <u>directly</u> insures U.S. investors overseas for both terrorism and political risk outside the United States. It would be ironic and senseless if TRIA, which is the only similar protection of the domestic economy and which, unlike the DOT and OPIC programs, is <u>not</u> a direct liability of the Federal Government, were allowed to expire or even linger in limbo through the remainder of this year.

Terrorism is the major threat facing our nation today. We hear about it on daily basis from the Administration, our national security team and from almost every corner of Capitol Hill. Whatever one's view of the wars in Iraq and Afghanistan, the threat of

attack to our country does not now seem to be diminishing. The threat of "enemy attack" is part of our daily lives and shows no sign of going away.

Terrorism risk remains an evolving picture that insurers and reinsurers have a difficult (if not impossible) time modeling. Primary insurers remain largely averse to exposing themselves to potentially catastrophic terrorism losses without adequate reinsurance, and the current private reinsurance market provides only a fraction of the capacity needed. This problem is evident in the fact that, as we once again approach the sunset of the TRIA program, many policies again are being issued with "pop-up" and "springing" exclusions that void terrorism coverage after termination of the Federal backstop. We witnessed the same sort of exclusions in 2005 before TRIA was extended for two years.

Quite simply, economic security is central to an effective homeland security strategy. American businesses must have adequate terrorism risk coverage. Without terrorism insurance, the nation's economic infrastructure is totally exposed to large-scale business disruptions after an attack, and to a retarded recovery from the damage that is caused by the attack. As our economic interests continue to be targeted by terrorists, it is appropriate, necessary and vital that the Federal Government play a role in maintaining the security of our insurance system which helps provide for recovery of the economy.

LONG TERM SOLUTION NEEDED

The conditions that necessitated TRIA and TRIEA – insurers that are not willing or able to quantify man-made risks which are potentially catastrophic and a withdrawal of all significant reinsurance capacity – have not gone away. We believe that the time has come for Congress to enact a long-term solution for insuring against terror – one that is either permanent or at least guaranteed to be in place until Congress declares that terrorism is no longer a risk. At least fourteen other major industrial nations have recognized that the private markets are unable to effectively manage terrorism risk and have adopted permanent national programs. The US market is no different. Terrorism risk is a national problem that requires a Federal solution.

We believe that the Federal role should focus most heavily on what the private markets have been unwilling or unable to do: enabling policyholders to purchase insurance for the most catastrophic conventional terrorism risks; ensuring adequate capacity in high risk, urban areas; and providing meaningful insurance for NBCR risks. A permanent program should also seek over time to reduce the Federal role in conventional terrorism markets and maximize long-term private capacity by facilitating entry of new capital. We believe that over time the private market may be able to develop enough capacity to address many terrorism risks, but the risk of truly catastrophic events – involving both conventional attacks in urban areas as well as NBCR terrorism everywhere– will continue to be virtually uninsurable without some sort of Federal program in place.

CIAT has developed a set of principles for a long-term solution, and I will devote the remainder of my testimony to describing this plan.

CIAT'S PRINCIPLES FOR TRIA MODERNIZATION

The CIAT proposal seeks to make sure there is adequate terrorism insurance capacity in the market in the future, particularly for high risk areas; to ensure that NBCR risks will be covered; and to ensure that the Federal government will have an insurance mechanism in place so that the nation can more easily and efficiently recover from a truly catastrophic attack—whether due to conventional or unconventional terrorism. At the same time our proposal seeks to minimize over time the role of the Federal government for conventional terrorism.

Conventional Terrorism Risk

For risk of conventional (i.e., non-NBCR) terrorism attacks, the CIAT proposal would leave in place the TRIA backstop, with the insurer deductibles, industry retention, and program trigger all maintained at no higher than their 2007 levels. This ensures that policyholders will continue to have access to coverage through the "make available" provision.

While TRIA has been largely successful in making available private direct insurance coverage against conventional terrorism attacks, it has not been without some continuing problems of availability and affordability. There are major markets today, particularly high-risk urban areas with prescribed fire-following policy forms, where the combination of aggregation of risk, high retention rates and rating agency pressure are causing capacity problems for conventional terrorism coverage. Thus, Congress and the Federal government need to continue the statutory framework that is known as TRIA for conventional terrorism exposure, but this framework needs to be modernized to reflect the continuing market realities of capacity shortfalls in some areas. This is one of the reasons why CIAT favors raising the $100 billion annual program cap (which has not even been indexed for property values or general inflation in the five years since the TRIA program began).

However, CIAT also suggests Subcommittee consideration of a privately-funded "Terrorism Risk Trust Fund" that would be maintained by Treasury and used to help cover a portion of the Federal share of insured losses under the TRIA program. The trust fund, for example, could be funded with both "pre-event" (i) assessments on insurers and (ii) matching surcharges on policyholders in an "above the line" amount separate and discrete from their property/casualty insurance premium (and therefore not be subject to state rate approval).

These collections could be forwarded to Treasury where they would be managed in a segregated, tax-free trust or maintained in a separate corporation similar to the FDIC. Treasury would get the benefit of the surcharged accounts which would have the effect of decreasing the government's exposure as the trust fund grew over time. For example, even a 1% surcharge on the premiums in the TRIEA covered lines – with a matching 1% insurer assessment – together with a conservative investment return (government bond rate) would grow to tens of billions of dollars in capital in the same amount of time that TRIA has already been in place.

We believe that, over time, this trust fund will accumulate enough capital through these pre-event surcharges and assessments that the likelihood of taxpayer exposure to

terrorism risk will be limited to only the most extreme events. The result would be a public-private partnership that will reduce the Federal role and maximize private capacity. We also note that the use of "pre-event" surcharges in our proposal does not in any way effect the operation of post-event surcharges for purposes of recoupment that are already in the TRIA program.

NBCR Terrorism Risk

NBCR terrorism risk is a different matter. Even if the Federal backstop exposure to conventional terrorism can be reduced over time to all but the most catastrophic attacks, the challenges are different for NBCR, according to all of the expert actuarial estimates. As it presently stands, although TRIA covers NBCR perils, we have not seen any evidence that such coverage is being written except where mandated for workers compensation. Because TRIA only requires that terrorism coverage be made available on the same terms, amounts and limitations as non-terrorism perils, insurers are not required to make NBCR terrorism coverage available if NBCR coverage for non-terror events is not offered.

The GAO, the Treasury Department, and the President's Working Group have all recognized that markets simply cannot price the risks associated with NBCR perils. Accordingly, we believe that this is a crucial area that the long-term solution should address.

Our proposal would embrace several features from the 2005 House-passed extension bill, H.R. 4314: it would add NBCR perils to the "make available" requirement under TRIA and would call for lower insurer deductibles and co-pays with respect to NBCR risks, creating a separate formula to determine the industry retentions. The proposal would also remove the annual $100 billion program cap, to clarify that insurers are not liable for truly catastrophic attacks – whether NBCR or conventional. With such confirmation of protection against the most catastrophic attacks, private insurers should be able and willing to devote more of their existing capacity to conventional terrorism risks as well.

Other Changes

CIAT urges removal the distinction between foreign and domestic terrorism in the statute's definition of "act of terrorism." This distinction may force the Treasury Secretary to make determinations that may not serve our national security needs, and it serves no sound policy goal. As the London bombings demonstrated all to well, there can be serious difficulties in distinguishing between foreign and domestic terrorism, and the distinction makes no difference to the victims. We commend this Subcommittee and the House as a whole for adopting that change in 2005 in H.R. 4314, although the feature did not survive in the final legislation.

Finally, in order to enhance the stability of our financial markets, the modernized program should be made permanent – or should be in place at least until Congress declares that terrorism is no longer a risk.

In all, we believe that the CIAT-endorsed modernization principles for TRIA will reduce the Federal role over time but ensure economic security by keeping a backstop in place for the most extreme and catastrophic attacks, whether conventional or NBCR. We think it is a fair measure and we urge the Subcommittee and Congress to incorporate these features into the measure to be adopted this year.

CONCLUSION

Again, we applaud you for making long-term renewal of TRIA solution a priority early in the year, and we thank you for the opportunity to testify at this important hearing. We urge you to incorporate the CIAT principles in your renewal legislation. As always, CIAT is committed to working with you, the insurance community, and other stakeholders in crafting a meaningful long-term solution as swiftly as possible.

STATEMENT OF WARREN HECK
CHAIRMAN AND CEO

GREATER NEW YORK MUTUAL INSURANCE COMPANY,
INSURANCE COMPANY OF GREATER NEW YORK
AND STRATHMORE INSURANCE COMPANY

ON BEHALF OF
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

AT THE HEARING ON

THE NEED TO EXTEND THE TERRORISM RISK INSURANCE ACT

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

HOUSE COMMITTEE ON FINANCIAL SERVICES

NEW YORK, NEW YORK

MARCH 5, 2007

Chairman Kanjorski, Ranking Member Pryce and Members of the Subcommittees, my name is Warren Heck. I am Chairman and Chief Executive Officer of the Greater New York Mutual Insurance Company (GNY) and its wholly owned stock subsidiaries, Insurance Company of Greater New York and Strathmore Insurance Company.

It is fitting that the Subcommittee has chosen New York City as the site of its hearing on the need to extend the Terrorism Risk Insurance Act. I am convinced that the ability of the City to regain its economic strength and its very soul after the terrible devastation wreaked on it and its residents on 9/11 is due, in substantial part, to the wisdom of this Committee and the Congress in enacting the Terrorism Risk Insurance Act (TRIA) in 2002. The Act not only helped rescue the City; it played a major role in preventing a national economic catastrophe and helping get the country back on its feet economically. I am convinced that the recovery would not have occurred as swiftly as it has or continued, absent adoption of TRIA and its extension in 2005, the Terrorism Risk Insurance Extension Act (TRIEA).

However, as you know, TRIEA expires on December 31, 2007, and I am deeply concerned that if Congress does not adopt a long-term private/public terrorism risk insurance program, many of our citizens who need terrorism coverage to operate their businesses all across the nation will be either unable to get insurance or unable to afford the coverage that is available.

Greater New York Mutual Insurance Company's history and post 9/11 experience

Let me describe my experience as a medium-sized insurer of commercial properties in New York and my reasons for supporting a long-term terrorism insurance program that would maximize the development of the private market and provide a viable long-term system to protect the economic strength of the country against terrorist attacks.

While I am here today to testify on behalf of my own company, my perspective has also been shaped by my experience serving as the Chairman of the National Association of Mutual Insurance Companies (NAMIC) TRIA Task Force since 2004.

First, let me tell you a little bit about our companies and our experience with the terrorism risk, because we have been on the frontlines of this problem ever since 9/11. As with many mutual insurance companies, whether they are rural, farm, or specific to a particular industry, GNY began in the early 1900s at a time when there was a huge flood of immigration into the United States from Europe. Many of these immigrants settled in the lower East Side of New York City and earned their living as plumbers, electricians, steel workers, carpenters and in other trades. Many of them scrimped and saved and put all they had in the purchase of a tenement apartment house; however, they found it difficult to obtain liability insurance for their properties because the tenement apartment houses were extremely crowded and because of burgeoning litigation at that time. These tenement apartment house owners formed a trade association to protect their interests and to which they gave the name, Greater New York Taxpayers Association. This lack of insurance availability motivated the association to form an insurance company that became the Greater New York Mutual Insurance Company, as it is known today. Our legacy is that of early immigrants who came from humble beginnings as trades people with little formal

education who started the insurance operation applying solid business principles and practices to their work.

Today, the company is a multi-line regional commercial lines company operating in New York, New Jersey, Connecticut, Massachusetts, Pennsylvania, Maryland, New Hampshire, Delaware, Virginia and Washington, D.C. The majority of our business is in New York, New Jersey and Connecticut, where we have done business for many years; we began developing business in the other listed states in recent years. Our companies have had an A+ rating from A.M. Best for many years, and an A rating from S & P.

In New York State in 2006, our companies wrote direct written premium of $190,920,362 of which $171,055,970 was Commercial Multi Peril, making us the fourth largest writer of Commercial Multi Peril business in New York State. In New Jersey in 2006, we wrote direct written premium of $74,337,700 of which $60,081,494 was Commercial Multi Peril, making us the fifth largest writer of that business in the State of New Jersey. For many years, we have been the largest writer of co-op apartment houses in the boroughs of New York, particularly Manhattan, and the leading writer of apartment buildings in the state.

Although I have served as President and Chief Operating Officer of the company for 18 years and Chairman and CEO for the past five years, I have also continued to serve as Chief Underwriting Officer, in which role I manage the underwriting activities of our companies. This has enabled me to have first-hand knowledge and understanding of the needs of our policyholders and agents, particularly with respect to the terrorism exposure.

As a result of the terrorist attack on 9/11, and prior to the passage of TRIA in late 2002, most primary insurance carriers operating in New York City began to non-renew their commercial property and workers' compensation business, or reduce limits of coverage to levels below what was needed by the business community. Most primary companies refused to insure property on buildings with values in excess of $20 million, and would not insure any risk that had more than a limited number of employees in a single building. The extreme hard market for property and workers' compensation coverage in New York State, particularly in New York City, was worse than other places because New York State prohibited carriers from excluding coverage for terrorism, and reinsurance companies universally excluded terrorist acts in property and casualty treaties. The only alternative was to offer less coverage or not write the business at all.

The few companies willing to provide coverage increased their prices because of the significant terrorism exposure. However, many of those companies began to cut back when concentrations of values and employees became too large. The lack of insurance capacity had a negative impact on the New York economy resulting in the postponement of many construction projects, lack of or inadequate property coverage for many commercial office buildings, and significant increases in pricing of commercial multi-peril business.

With the passage of TRIA, the fear that a worst case terrorist event could render our company insolvent was somewhat reduced, making it possible for our company to continue to do business in New York City and other urban areas. TRIA placed a ceiling on individual company

terrorism losses, which permitted our company to quantify its terrorism exposure and find a way to address the situation.

We devised a new underwriting strategy and guidelines that permitted underwriters to insure skyscraper office buildings up to $50 million or more depending upon risk accumulations in a given area of the city and proximity to so-called target buildings. We also do not insure commercial tenants in a property where the company insures the building. With respect to workers' compensation coverage, as long as employee counts were not too concentrated, our company considered offering coverage. We also implemented a computer system to geo track risk accumulations to the street level as well as the number of employees in a given building, and risk concentrations by zip code. Since the passage of TRIA, we have purchased very expensive stand-alone terrorism reinsurance to cover as much of our TRIA deductible and co-insurance as we could reasonably afford. Without the passage of TRIA and TRIEA, our company could not have kept its market open in the same way in New York City and retained the insurance capacity needed to write new business and grow its direct written premium.

The need for a long-term private/public terrorism risk insurance partnership

Five and a half years out from 9/11, with no other terrorist attacks on U.S. soil, terrorism reinsurance availability remains limited, and without TRIA and TRIEA the primary insurance market would have dried up in large urban centers. In those states that mandate that insurers offer terrorism risk coverage, insurers would have had to make the difficult decision to either offer terrorism coverage or leave those markets. These problems flow from the simple, inescapable fact that terrorism insurance is a classic uninsurable risk.

In order for the private market to function efficiently, it needs to be able to make actuarial judgments based upon an historical record of frequency and severity of an event. Years of data make it relatively easy to estimate auto insurance costs. Homeowners' insurance costs are somewhat less predictable because of the uncertainty and timing of calamities such as windstorms, earthquakes, and wildfires, but we can model natural catastrophic events because we have long historical records and sophisticated geological studies and hurricane forecasting methods to help us predict the future. We can also differentiate among risks based on such factors as location and the mitigation efforts of homeowners.

When it comes to terrorism risk insurance, we have no basis for estimating frequency. President Bush and other leaders of our government tell us that there *will* be – not *may* be – another terrorist attack on our soil. They cannot tell us when or where it might occur or its likely nature. Harder still from an insurance perspective, we cannot predict its severity. Will it look like 9/11 or last year's foiled attempt to blow up multiple airplanes over the ocean? What we do know is that our enemies want to inflict massive casualties and that terrorists have the expertise to invent a wide range of attacks, including those involving the use of chemical, biological, radiological and even nuclear weapons. While exploding a small nuclear weapon in a major city could do incalculable harm to hundreds of thousands of people, as well as to businesses and the economy, exploding multiple bombs in one or more places with no NBCR components could also wreak massive damage. The damages could reach into the hundreds of billions, levels that only the federal government can afford to pay.

Since 9/11 we have been working on improvements to our modeling technology in an attempt to quantify our terrorism exposures and reduce our concentrations in New York City. As previously mentioned, we have also geographically diversified our writings by expanding into suburban regions in other states. However, there is no guarantee that, for example, limiting one's exposure in New York City by underwriting risks in the U.S. heartland will succeed, as low-tech attacks such as those in Madrid and London could cause enormous economic harm if replicated in shopping malls in the South and Midwest. Even greater harm could be caused in these areas if terrorists attacked chemical plants or the food supply.

Smaller insurers, which comprise a large portion of NAMIC member companies, face additional problems because they operate in only a few counties in a state or in only a few states. They simply lack the financial resources to withstand a terrorist attack in their home areas. In addition, many of them today are in financial jeopardy because, when they write commercial insurance with the federal obligation to include terrorism coverage, they cannot get reinsurance to cover the higher deductibles in TRIEA.

Workers' compensation presents particular concentration risks. For workers' compensation, a private mutual insurance company or a state fund handles the bulk of insurance coverage for businesses in 27 states. Many of these companies, often characterized as guaranteed markets, must accept all applicants. While most large multi-line commercial insurers may limit the scope or aggregation of risks that they are willing to cover in a specific area, many private mutuals or state funds find themselves with tremendous risk concentration. The California State Fund best exemplifies this concentration of risk. It is the single largest writer of workers' compensation business in the United States despite the fact that it only operates in its own state.

Also relevant to this discussion is the fact that insurers do not operate in a free market in many states. State laws prohibit workers' compensation policies from excluding terrorism related losses, thus leaving many regional workers' compensation specialists in an extremely vulnerable position. Many of them have a high concentration of risk, a mandate to take all customers and an inability to exclude terror-related events that could potentially inflict catastrophic levels of human and economic devastation in particular areas or regions. Because of rate regulation in many states, insurers also are not free to charge what they believe is an actuarially sound price for the risk involved.

Even if an insurer were able to diversify its risk exposure through modeling and get sufficient private reinsurance to cover the TRIEA deductibles, the notion that the private market can protect itself through good modeling is flawed. Absent a terrorism insurance program, a $778 billion terrorist event—the high estimate for a single terrorist event by the American Academy of Actuaries in New York City—would wipe out more than the total property/casualty insurance industry surplus for all lines (both commercial and personal), which was estimated at $467.7 billion as of September 30, 2006 by the Insurance Information Institute. This would mean that the industry would be unable to meet its obligations to its other insureds for the many different coverages beyond terrorism insurance – such as auto and homeowners – that are protected by that surplus.

While the private market cannot cover events of such magnitude without either bankrupting insurers and reinsurers or wiping out so much insurer surplus that they could not meet their obligations on other lines of insurers, the private market does have the ability to cover lesser, clearly defined losses. TRIA and TRIEA were both reasonable attempts to limit the maximum exposure of insurers so that the private market can play a role in terrorism risk insurance. These statutes made a private/public bargain: Insurers would offer terrorism coverage in return for a guarantee from the federal government that it would pick up losses beyond the insurers' capacity. The purpose is not to protect insurers; it is to make sure that the economy can recover in as orderly a fashion as possible from the next terrorist event.

What would have happened to the property and casualty insurance market had there been no federal program to insure terrorism? My experience tells me that it would have been similar to what happened after 9/11. Insurers would have excluded terrorism risk unless required by states to offer it or withdrawn entirely from perceived terrorism-exposed areas. In urban centers like New York City, there would likely have been high demand and a low supply of terrorism insurance, forcing prices to increase (if permitted by state law) for the limited amount of terrorism insurance that would have been available, thereby inhibiting development and economic growth.

The caveats in the above paragraph with respect to mandatory coverage and rate regulation make the point that not having TRIA in the first place, or letting TRIEA expire, would not permit a free market test for terrorism insurance because terrorism insurance does not operate in a free market in the United States. For example, the state regulators in New York—the state many view as the most likely to be a terror target—have prohibited companies from excluding coverage for terrorism. There is no similar regulation requiring the reinsurance market to provide protection to the direct market, leaving insurers in a Catch 22 should TRIEA expire. Medium and small companies would face a difficult choice: leave the marketplace for terror target-area risks or face the prospect of a financial disaster that could result if they write coverage. To the extent that companies choose to leave the market, competition would be significantly reduced.

What about the capital markets? Would they have picked up the slack? There simply is no reason to believe the capital markets would have replaced the missing insurance capacity and there is no evidence that TRIEA has crowded out private market capacity. Terrorism risk has presented a real opportunity for reinsurers and they have not chosen to take on very much of this risk. The Reinsurance Association of America has indicated that worldwide capacity for terrorism risk in the United States is approximately $6 to $8 billion without NBCR, far below the amount needed. The capital markets have taken their cue from the reinsurance market. There have been very few terrorism catastrophe bonds issued and a visit last year by some insurers to Wall Street revealed that the potential market for such instruments might reach $1 - $2 billion, at best, over the next five years. Moreover, there is no capital market appetite whatsoever for bonds for nuclear, biological, chemical, and radiological (NBCR) events.

How would another terrorist attack have affected the resources of the federal government if there had been no TRIA program? Given the very limited amount of terrorism insurance that would have been available in the absence of TRIA, I think Hurricanes Katrina and Rita provide a

glimpse into that world. The federal commitment to cover the portion of the 2005 hurricane losses that exceeded private market coverage is closing in on $100 billion. Moreover, a significant portion of that money has been siphoned off by fraud because the government is not skilled at settling claims and doesn't have the manpower to handle a major catastrophic event.

If the federal government assumes such a huge responsibility for these natural catastrophes, as it has done in the past for other such extreme events, regardless of the party in power, then it seems a fair conclusion that the government would step in and actively help people harmed by a terrorist event. For people who believe that a terrorist attack in a part of the country where they do not live would not affect them, it is important to note two things. One, a large attack would hurt them directly by weakening the economy. It would also hurt them, perhaps somewhat less directly, by forcing the Congress to either cut programs or raise taxes to keep the deficit under control. In short, the cost of the losses would be borne by not just by the people where the attack occurred but also by taxpayers from Hawaii to New York, as well as from Alaska to Maine and all the states in between.

A long-term private/public terrorism insurance plan would reduce the federal government's exposure and provide for an orderly processing of claims. The result would be a speedier economic recovery for both the area that was attacked and for the economy as a whole. Moreover, in order to keep the federal budget deficit from reaching disastrous proportions, the Congress would have to either reduce funding for other programs or raise taxes, or both.

The shape of a long-term private/public terrorism risk insurance program

The insurance industry has been working to devise a long-term program for congressional consideration that would maximize private sector participation without threatening the economic viability of the industry.

While the interests of companies vary depending on such factors as size of surplus and geographic distribution of writings, there is broad agreement on the need to maximize private sector participation and to have the federal government provide a backstop if insured losses would be too great. That is the basis for the structure the Congress created in TRIA and TRIEA, with event triggers, insurer co-payments and industry deductibles as the means for maximizing private sector participation. This structure makes sense for "conventional" terrorist events that do not involve the use of NBCR elements. However, it is worth exploring ways to encourage more private sector participation. One way might be to create a federally chartered entity to facilitate reinsurance capacity below the insurance industry's aggregate retention level. With voluntary insurer participation, this "middle layer" of potential risk-bearing capacity would provide the kind of private market test that some in the Congress believe is needed. If the effort is successful, then the federal government's responsibility could recede. If not, then we would know that we have maximized private market capacity.

The NAMIC TRIA Task Force to which I referred earlier made an important observation concerning the effect of the current TRIEA program's escalating event trigger level on the ability of small and medium-sized insurers to participate in providing terrorism risk insurance. The Task Force concluded that, for such companies, the event trigger is the key to their ability to

continue to provide coverage. Too high a trigger would drive them from the market because reinsurance costs would be too high, making primary coverage unaffordable. As a medium-sized insurer in New York that covers some very large buildings, I can tell you that a trigger in excess of $50 million would severely limit GNY's ability to offer as much coverage as it now offers. I simply could not justify to policyholders or state regulators my company's decision to take such a large risk relative to the size of the company's surplus. Furthermore, my company would risk a downgrade in our financial strength rating by rating agencies under new requirements that insurers provide information about their exposure to terrorism risk including estimated potential insured losses resulting from simulated terrorism events.

Why should Congress care about maintaining a market for smaller carriers? The answer is simple. Large companies do not operate in all areas and markets. Small and medium-sized insurance carriers, those with annual direct written premium of less than $1 billion, inject competition in markets where little or none exists, provide coverage that would otherwise be unavailable in certain regions and serve specific niche markets that many larger carriers have avoided since 9/11.

In 2004, of the 2,100 property and casualty insurance companies operating in the United States, only 40 had writings in excess of $1 billion and only 58 had policyholder surplus in excess of $1 billion. Of the 1,028 companies that write TRIEA exposures, 94 percent have less than $1 billion in surplus. Small and medium-sized companies represent 83 percent of all companies writing workers' compensation, with 27.2 percent of the premiums.

A high event trigger would force small and medium-sized companies to exit the market, which would erode capital rather than build it. A smaller private insurance market would further expose the federal government to greater costs should another terrorist attack occur.

In order to assure their continued involvement in the sale of terrorism risk insurance, I believe that the trigger in any long-term program should be set at a level that will continue to encourage their participation. If the event trigger is too high and we are forced to withdraw, there will be many markets where the large insurers will not take up the slack, resulting in serious harm to policyholder companies in those markets. While the cost to the federal government of a long-term trigger of $50 million would be negligible, the cost to these companies of a higher trigger would be too much for them to assume and the cost to the economy could be overwhelming.

I'd like to make one more comment on a long-term program. While the capital markets have limited appetite for terrorism risk, they have almost no appetite for NBCR coverage. In order to make limited coverage available, and bearing in mind the inevitable involvement of the federal government should such an event take place, I would recommend the federal assumption of NBCR risk on a reinsurance basis for certain losses, with perhaps the first $10 billion of loss to the federal plan reimbursed by a post-loss assessment as a percentage of industry premium in covered lines.

I would also recommend ending the distinction in existing law between foreign and domestic terrorist events, with only the former covered. Events subsequent to 9/11 have demonstrated that there are many home-grown terrorist cells around the world and, undoubtedly, there are some in

the United States as well. The damage to our nation would be just as great whether the source of a particular terrorist attack is foreign or domestic. Moreover, an attack could involve both foreign and domestic elements or it might be very difficult to identify conclusively where the perpetrators are from. That is why I recommend that the next legislation include both kinds of terrorist events so that the country does not run the risk of finding itself in some bureaucratic limbo while we sort out the source of the destruction.

Finally, NAMIC supports a long-term program. Absent an extended reauthorization, the markets would see the kind of disruption that occurred at the time TRIA was scheduled to expire in 2005, with companies scurrying to address the uncertainty, often asking state officials to permit them to provide exclusions in future contracts and sometimes making plans to withdraw from certain markets or restrict coverage, The situation was chaotic for all concerned, both companies and policyholders, and a long-term program would avoid such disruptions again. Is there a magic number? No, but I would think it should be at least five to 10 years in length to create the necessary certainty. Should subsequent events suggest the need for changes in the interim, there would be nothing to prevent the Congress from revisiting the issue before then.

For a more detailed description of NAMIC's views regarding a long-term proposal, I am attaching NAMIC's Statement of Principles on Terrorism Risk Insurance.

Mr. Chairman and Members of the Subcommittee, thank you once again for the opportunity to testify on this issue of vital importance to myself, NAMIC member companies and the U.S. economy. Your continuing leadership on this issue represents the best in public policymaking and we stand ready to assist you in any way in developing an effective long-term terrorism insurance plan.

ATTACHMENT

NAMIC STATEMENT OF PRINICPLES ON TERRORISM RISK INSURANCE

1. Terrorism is an ongoing threat to the people and government of the United States. Therefore, a long term insurance industry program coupled with a government backstop at an appropriate level of loss is essential to assuring an orderly economic recovery and reconstruction effort after any significant terrorist attack.
2. The Terrorism Risk Insurance Extension Act of 2005 (TRIEA) is a temporary measure. The nation's economic security requires a long-term private/public sector program.
3. The government backstop was established under the Terrorism Risk Insurance Act of 2002 (TRIA) and extended under TRIEA because there was, and still is, insufficient private sector terrorism insurance and reinsurance coverage to provide adequate coverage in the event of another large-scale terrorist attack.
4. A long-term private/public terrorism insurance program is necessary because terrorism is fundamentally an uninsurable risk, due to the inability of insurers to predict when events will occur and because of the potentially catastrophic costs of an attack.
5. To be effective, a permanent terrorism program must allocate the costs of terrorism events between the private and public sector in a way that maximizes private sector involvement while assuring that private insurers can continue to meet their obligations across all economic sectors and insurance product lines after a terrorism event.
6. The goal of public policymakers should be to allow the private sector to take on more of the risk over time by enacting a long-term terrorism insurance plan that will enable insurers and reinsurers to gradually develop additional capacity in order to provide coverage to businesses and property owners that need it.
7. We recommend adoption of a three-tier solution.
   1. The first layer would consist of private primary insurance and reinsurance, as exists under TRIEA, and would include the following elements:
      - Small and medium-sized insurance carriers form the backbone of the industry and support niches of terrorism coverage larger carriers have historically avoided.
      - A permanent event trigger should be set at a level that will continue to encourage participation by small and medium-sized insurers. Too high a trigger would drive them from the market because reinsurance costs would be too high, making primary coverage unaffordable.
      - Individual company deductibles and the industry retention level should be tied to premium income, but set at levels that would enable the industry to continue to meet its other claims obligations and perform its economic role after paying off its share of the losses from a terrorist attack.
      - State laws that (a) prohibit insurers from excluding terrorism and (b) prevent the free market from setting adequate rates for terrorism insurance should be preempted.
   2. The second layer would be an industry-sponsored reinsurance facility to encourage the development of new private sector capital for terrorism. It would act as a bridge between the purely private sector layer and the private/public sector liquidity backstop in the third layer.

  - Initially it might cover losses of about $10 billion to determine how much private sector capacity can be developed from the capital markets.
  - U.S. companies eligible to access recoveries from this facility would fund the initial and ongoing capitalization through a policyholder surcharge.
  - The facility should be authorized to purchase reinsurance protection.
  - The facility would collect premiums and provide Industry Loss Warranty (ILW) reinsurance to insurers and reinsurers.
3. The third layer would be a private/public partnership that would provide a liquidity backstop in the wake of catastrophic terrorist events.
  - Outlays would be recovered, in part, by a fixed annual policyholder surcharge.
  - Aggregate annual financial protection would be provided for 90 percent of all eligible losses, losses beyond those covered by the first two tiers, up to $100 billion.

8. In addition, we recommend a separate federal reinsurance program for losses arising from NBCR attacks.
  - For losses covered by private reinsurance (e.g., worker's compensation, fire following), the program would provide first-dollar reinsurance.
  - For losses not covered, but that would be covered in the absence of an NBCR exclusion, a direct federal NBCR insurance rider should be created, to be administered by the insurer on a follow-form basis.
  - The first $10 billion of insured losses paid for by the federal plan should be reimbursed by a post-loss assessment as a percentage of industry premiums in covered lines.
  - The NBCR program should apply to the commercial lines covered under TRIEA.
9. By encouraging the maximum private sector protection while recognizing the need for federal participation, a successful terrorism risk insurance program will reduce government exposure, increase the take-up rate for terrorism coverage among businesses and commercial property-owners, and thus reduce the costs the federal government would otherwise bear in the event of a catastrophic terrorist attack.

Testimony of

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U.S. House of Representatives
Committee on Financial Services

Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises

Hearing on Terrorism Insurance Risk Insurance

New York City

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Liberty Mutual appreciates the opportunity to submit this testimony in support of a long-term commitment to continue the public-private partnership that is the essence of the Terrorism Risk Insurance Act of 2002 (TRIA) and its successor, the Terrorism Risk Insurance Extension Act of 2005 (TRIEA). Rather than another short-term extension, we urge the Committee – on behalf of our customers, many of them employers and property owners here in New York City – to move quickly to meet the long-term terrorist challenge facing our nation.

A critical aspect of that challenge is to provide a durable bulwark against the potentially devastating economic consequence of a terrorist attack. The insurance mechanism can play a key role – as it did, profoundly, following September 11th – providing the financial resources to help people rebuild their lives and livelihoods following a terrorist attack. A long-term extension of TRIEA will enable the insurance industry to continue to perform this vital role. Without TRIEA, the industry's ability to serve its customers by providing the financial protection they need and deserve will be severely compromised and our nation's economy put at significant risk. Without a long-term TRIEA we will continue to be faced with the periodic disruptive effect of the uncertainty as to the availability of coverage.

There is no longer any serious debate that available terrorism risk insurance is an essential ingredient of our national defense against terrorism. The only question is the relative role of the federal government versus the private market. Liberty Mutual believes that the current law – the Terrorism Risk Insurance Extension Act – strikes an appropriate balance. Congress has acted wisely in constructing legislation that relies to the greatest

degree possible on the private insurance and reinsurance markets, although, as I will discuss, there are a few areas that need improvement or clarification. As a strong proponent of the private market's ability to respond to and manage financial risks, if we thought that TRIEA interfered in any way with the development of a private market for terrorism risk, we would be the first in line to call for its repeal. We are confident that without TRIEA there would be far less coverage available for terrorism risk and no voluntary coverage available for nuclear and related risks of mass destruction. It is the existence of TRIEA that enables the industry to offer terrorism risk coverage today...and so we call on this Committee and the Congress to pass a long-term extension of TRIEA .

For several reasons outlined below, a significant public-private partnership is essential for ensuring the availability of terrorism risk insurance.

UNDERSTANDING THE USE OF INSURANCE CAPITAL

Some people have suggested that since capital within the insurance industry is roughly $675 billion, the industry has sufficient capacity to assume the risk of terrorism. These estimates, however, include capital in the life, home, and auto insurance industry, which is not available for the terrorism risk addressed by TRIEA—as well as capital that underpins other business line risks. For example, at Liberty Mutual we have $12 billion in policyholder surplus, which supports all our policyholders including homeowners exposed to hurricane risk, automobile owners exposed to accidents, workers exposed to lost time and medical expense from workplace accidents, and others; our surplus is not just set aside to cover exposure to terrorist events.

Many terrorism loss scenarios are modeled at costs exceeding $100 billion and some very plausible events at $700 billion or more. Yet, the entire property and casualty insurance industry has only an estimated $151 billion of capital backing all risks - including fire, wind, accident or other insured perils - covered by TRIEA-backstopped policies.

Without TRIEA, there is the very real potential that terrorism-related losses would overwhelm the industry's ability to pay its customers' losses.

There are limited sources of new capital.

Sources of new capital are few and limited. Organic growth (operating income and investment returns) is slow, subject to taxation, and inadequate to the terrorism risk. This is true despite significant earnings across the industry in 2006 – even many years of strong earnings would be insufficient to build the capital base necessary to assume the risk of catastrophic terrorist-caused loss. The capital markets will not provide the answer, they are limited by prudent financial management, investors, regulators and rating agencies. Despite demand there has been minimal interest in Terrorism-Catastrophe bonds, unlike the case for hurricane catastrophes. Reinsurance is an option but global capacity is very limited for terrorism risk (estimated $6-8 billion) and almost none exists for NBCR (nuclear, biological, chemical, and radiological risk).

OPERATING IN A HIGHLY REGULATED MARKET

Some critics of TRIEA suggest government should get out of terrorism insurance completely. They say: let the free market handle terrorism. At Liberty Mutual, we fully believe free markets are better. Wherever we operate, we push hard for free markets. But

terrorism insurance is not a free market. In a free market, providers of products and services compete to sell those products and services. If the terms, conditions, or prices are inadequate, or if the risk of loss is too large, the provider has the option to withdraw. We cannot withdraw from terrorism insurance. For example, in each and every state (as discussed further below) workers compensation must cover all loss from terrorism. If pricing is inadequate, or exposure too great, the only way to avoid the risk is to completely withdraw from the workers compensation market.

Highly-Regulated Markets Present Distinct Challenges

Insurers operate in highly regulated environments. State insurance laws and regulations constrain capital and significantly limit the choices insurers can make to protect themselves from essentially unlimited terrorism exposure. Workers compensation is a particularly good example. Under state workers compensation laws, employers must purchase coverage to protect their employees. Insurers that provide this critically important insurance are required to do so without exclusions or limits of any kind. Thus the potential for large losses from terrorism, even for a single employer, can be very great. For example, the value of survivor's benefits for a 42-year-old spouse with two children is about $4 million in Massachusetts. A terrorist attack resulting in 1,000 deaths at a Liberty Mutual insured workplace in Massachusetts could cost us $4 billion – or about a third of our policyholder surplus. As we learned in 2001, not very far from here, 1,000 deaths or more from a single terrorist attack is a very real risk.

Regulatory requirements on commercial property insurance further accentuate the challenge. Insurers face mandatory "fire following" coverage in standard fire policies in

certain major market states including California, Illinois, and here in New York. Therefore, terrorism risk cannot be effectively excluded. Beyond commercial property, insurers are constrained by rate and form regulation in all lines of insurance. For example, Florida, Georgia, and New York only permit terrorism exclusions to the extent customers elect not to purchase coverage. Absent TRIEA and its mandatory "make available" requirement, the industry would have to provide the coverage in all cases or withdraw from the market.

Finally, insurers are required to participate in funding residual market coverage for those who cannot obtain insurance in the voluntary market. And, insurers must pay assessments so that guaranty funds in each state can pay the claims of policyholders of insolvent insurers. Thus, whether or not we reduce our exposure to terrorism risk, Liberty Mutual remains exposed to the losses and underwriting judgment of others.

These regulatory requirements restrict the industry's ability to manage its exposure to unpredictable and large-scale terrorism risk.

A FIDUCIARY OBLIGATION TO PROTECT CAPITAL

There is a limited amount of capital any company could make available to underwrite terrorism risk. Each company has its own risk parameters, its own risk appetite, its own return objectives, its own view of the risk, and its own methods of allocation of capital to various risks. In the end, every company has a limited amount of capital to make available to underwrite terrorism; to expose more than that to the risk would be a breach of fiduciary responsibility.

Alternative is Reduced Exposure to Terrorism Risk

In the absence of TRIEA or a similar public-private partnership, insurers would be unable to add sufficient capacity from private sector sources; therefore, we would have to significantly reduce exposure to terrorism risk. First, we could try to reduce exposure by using coverage exclusions or limits. But, as discussed, those tools are not available anywhere in workers compensation or for property insurance in certain standard fire policy states. Second, we could manage risk concentrations to ensure against over-exposure to terrorism risk in certain customer locations and geographic areas. To do so, we would utilize geo-coding and other data on the number of policies, employees, and property values in specific locations. To keep concentrations low, we would shed risk by ceasing to write certain risks in certain areas or by not renewing existing coverages. These choices, while not made easily, would be necessary in the absence of TRIEA, and would also have a hugely negative effect on the economy, as businesses would be unable to get needed insurance coverage.

RISK OF RUIN

Since company deductibles are so large, TRIEA would reimburse the industry only if a truly significant event occurred. At Liberty Mutual for example, our TRIEA deductible is $1.6 billion. A backstop that protects us from a loss exceeding such a large deductible is hardly a handout – especially considering we're offering coverage we would otherwise not offer, or would offer on significantly different terms.

So the challenge moving forward is to create a mechanism that achieves two goals. First, to make certain needed insurance is available for economic growth by creating a structure in which insurance companies can write the coverages businesses need to manage

their risk without exposing themselves to financial ruin. And second, we need a vehicle that encourages the private market to develop financial responses to terrorism.

LONG-TERM TERRORISM RISK INSURANCE PROGRAM

Liberty Mutual believes that TRIA and TRIEA have worked exactly as intended to promote the availability of terrorism risk insurance at commercially reasonable prices. This essential public-private partnership should be extended on substantially the same terms as it was conceived in 2002 and amended in 2005 for as long as the terrorist threat persists.

The structure of TRIEA is sound. By establishing a per-company "deductible," each company is responsible for its own underwriting decisions. Unlike pools or similar mechanisms that distort the market by forcing some companies to live with the bad underwriting decisions of others, TRIEA defines the level of risk to be managed by the private market – one company at a time. After all, the industry doesn't write insurance – individual companies do. We urge the Committee to keep the current structure of TRIEA intact.

However, we believe serious consideration should be given to improving TRIEA in three important ways:

First, extend the law indefinitely – or until the President determines that the threat of terrorism to the homeland has ceased. Short-term extensions cause market uncertainty as sellers can't offer and buyers can't depend on coverage for terrorist risk. This is particularly disruptive of large scale, long duration real estate projects, but it also has negative consequences across the commercial markets.

Second, eliminate the artificial distinction between foreign and domestic terrorism. If the purpose of the law is to provide economic stability by maximizing use of the private insurance mechanism, it makes no sense to exclude from that protection acts of domestic terrorism.

Third, consider removing or enlarging the program cap at least as it relates to nuclear, biological, chemical, and radiological risk, and clarify that private companies have no responsibility for NBCR losses above $100 billion, once they have met their own deductibles. Simply put, NBCR risk is not insurable in the private market. Only the federal government has the responsibility and the resources to respond.

The potential human and economic consequences of an NBCR event are frightening. According to modeling by the American Academy of Actuaries, a single large-scale NBCR attack has the potential to cause insured losses of $700 billion or more depending on weapon type and location. A medium scale NBCR attack in a major U.S. city could result in insured losses in excess of $100 billion. Beyond the costs of compensation, NBCR attacks would disrupt the economy and shut off sources of insurance industry capital to pay current and future claims – both related to the terrorist event and the ongoing claims. Moreover, losses from NBCR attacks could take years to quantify. Unlike damages from conventional attacks, NBCR damages will take much longer to determine given the latent nature of potential injuries. Also, the public's reaction to such an event can bring additional, yet unforeseen economic and emotional damages. Such extreme and long-term uncertainty means the insurance industry cannot assume the risk.

Given the unique properties of NBCR risk, insurers and reinsurers have historically excluded such risk from their contracts. The major exceptions are workers compensation and, in some states, property insurance where exclusions by primary insurers are not permitted – although reinsurers routinely exclude all NBCR. NBCR risk remains outside the capability and capacity of the insurance industry. Thus, NBCR risk should receive differential treatment, distinct from the risk of conventional terrorism, in any legislative successor to TRIEA.

We believe that these improvements to TRIEA – long-term extension, coverage for domestic terrorism, and expanded federal role for NBCR risk – effectively and fairly balance the public and private roles. The private market remains responsible for both conventional and NBCR risk up to its aggregate deductible and co-pay – roughly $42.5 billion - and is subject to potential surcharges for any federal dollars expended up to $100 billion. The federal government acts as a high level backstop in the case of conventional terrorism risk, and assumes an appropriately larger role in the case of a nuclear or similar attack.

Liberty Mutual is committed to working with this Committee and others in our industry and in the policyholder community to establish a public/private partnership that makes terrorism insurance coverage available for the long-term.

Thank you.

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United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Submitted via electronic mail to fsctestimony@mail.house.gov

Statement of John N. Lieber
before a Hearing of
the Committee on Financial Services
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
City Council Chambers, New York City Hall, 2nd Floor,
133 Duane Street, New York, New York
"The Need to Extend the Terrorism Risk Insurance Act"

March 5, 2007

Introduction:

Chairman Frank, Chairman Kanjorski, Ranking Member Pryce, members of the committee – Good Morning. My name is Janno Lieber. I am Senior Vice President at Silverstein Properties, where I have overall responsibility for the World Trade Center rebuilding project. I'm here this morning to testify not only on behalf of the Silverstein organization, but also on behalf of the Real Estate Board of New York (REBNY) and its members. Over the past few years, REBNY has been an effective leader on this very important issue of terrorism insurance. Thanks are particularly due to the efforts of two members of the REBNY Board who – in addition to leading a couple of the most substantial real estate firms in the entire country -- have spent countless hours on this issue: Steve Green, who is testifying with me here today, and Bill Rudin. I should also acknowledge the work of Steve Spinola, the President of REBNY, and Marolyn Davenport of his staff.

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Thank you for making the trip to New York City. Over the past five years, this committee has given New York and its people tremendous support as we have faced the various impacts of 9.11 -- not least in the area of terrorism insurance. I'd also like to thank Chairman Kanjorski and Congresswoman Pryce for scheduling this hearing early in the session, and for making TRIA extension a priority.

Background:

As you know, the Silverstein organization leased the commercial office portions of the World Trade Center site from the Port Authority of New York and New Jersey just six weeks prior to September 11, 2001. Since that terrible day, our entire effort has been focused on rebuilding lower Manhattan as a dynamic mixed-use district, including a Memorial commemorating the 2,749 lives lost.

After several years of planning and extensive public dialogue, all parties are united as to what will be built at the World Trade Center – and also where, when and by whom. In late 2006, the new business arrangements between Silverstein Properties and our partners at the Port Authority of New York and New Jersey were formally and finally agreed upon – with the full support of the State of New York, the State of New Jersey and the City of New York. This means that the entire World Trade Center site -- including four exceptional skyscrapers designed by world-renowned architects -- will be rebuilt by 2012. You saw the beginnings of this work when you visited the site this morning. These soaring towers will make a magnificent contribution to the rebirth of lower Manhattan, joining the Calatrava-designed PATH Transportation Hub, expanded retail, a new Performing Arts Center, and, of course, the Memorial to make lower Manhattan one of the most exceptional places in the world.

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Over the past few years, since the enactment of TRIA, the private insurance market has rebounded -- to a degree. However, in some areas, especially densely developed areas perceived as "high risk," there is simply insufficient insurance capacity – both terrorism insurance, and other insurances that have a terrorism component, such as builder's risk insurance. Thus, the circumstances that prompted Congress to create TRIA – *a shortage or unavailability of insurance, threatening market disruption* – still prevail. As detailed below, this is very much the case in lower Manhattan, which has suffered two terrorist attacks since 1993. Worse, there is a very real possibility that the expiration of TRIA or the program's inability to deal with lower Manhattan's unique circumstances could actually *trigger* a halt to the rebuilding of the World Trade Center and the rest of lower Manhattan.

We believe the debate about TRIA ought to focus less on the insurance industry and more on the policyholders – the owners, builders and managers of commercial and residential real estate in New York City. TRIA was designed to assure that terrorism insurance would be available and affordable to policyholders in order to protect the jobs in our buildings and the construction jobs that follow from our ability to develop buildings – including large-scale development projects like the one you saw this morning at Ground Zero. While reports indicate it is working reasonably well on a national scale, here in New York City – the largest real estate market in the country – it has been only partly successful, and there is a need for additional steps to encourage the insurance industry to make more capacity available.

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Need for Permanent or Long-Term TRIA Extension:

The most important action Congress can take to assure availability of terrorism coverage for densely developed areas like New York City is to extend TRIA either permanently or for a very long period, i.e., no less than fifteen years. A long-term program is necessitated by the basic realities of how buildings are financed, built and insured on large-scale development projects. Large-scale developments -- a category that includes a very large portion of the projects in New York City -- can take a very long time from start to finish, including a three-to-five year design, planning and approval process, followed by several years of construction, and another few years of lease-up. TRIA needs to be tailored to match the timelines and exposures that the construction industry, lenders and insurers analyze when making decisions about whether to build, finance or insure these large-scale projects. The failure to do so will create inefficiencies in the market and impede new construction. And a short term renewal will not solve this problem.

Focus first on how the duration of the TRIA program impacts on the financing process. Today, most large commercial loans are securitized in order to create bonds that are purchased by institutional investors. Lenders often do not hold the loans that they originate, but usually sell all or a portion of the loans for regulatory or liquidity reasons. In order to receive investment-grade ratings from credit rating agencies -- which are often necessary to get investors to purchase the bonds -- the underlying collateral must be secured. The potential that a project might lose access to terrorism coverage -- for example, if the TRIA program expired – will impact on a project's ability to obtain an investment-grade rating; this is especially true of construction projects in highly

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concentrated, "high-risk" areas like Midtown or lower Manhattan. The federal backstop provided by TRIA, of course, does not guarantee that the insurance industry will actually make terrorism coverage available in these and other "high-risk" areas, or in adequate amounts; other changes to the program will be necessary to accomplish that goal. However, making the program permanent at least eliminates the risk that rating agencies must account for the possibility that a project will be unable to purchase insurance in the marketplace because the federal backstop has disappeared.

There are other lender concerns that should be taken into consideration in determining the duration of the TRIA program. A substantial percentage of large, fixed-rate commercial loans are for terms of at least ten years -- in some cases longer. If the term of a loan exceeds the length of a TRIA extension, the lenders must assess the risk of having to terminate the loan early because the borrower defaults on the covenant to maintain specified terrorism coverage. Alternatively, the lender will simply decide not to write the loans for a longer period than TRIA or not to write such loans at all.

Another aspect of the financing issue is that construction lenders need to know that permanent financing will be available to re-pay construction loans at the time of project completion -- financing that may not be available if TRIA has expired before the project is completed and the buildings are fully leased. Further, project participants – including construction managers, contractors, owners, and lenders – normally require that project insurance policies be *non-cancelable* during the course of construction. Some insurers will reserve the right to cancel if reinsurance changes. A long term extension of TRIA is necessary to give all parties the confidence that terrorism insurance would *not* be cancelled as a result of the disappearance of the federal backstop.

In short, lenders, builders, and owners – who make up the membership of REBNY -- cannot embark on high-value construction projects where it is impossible to get insurance to protect against the risk of a loss. Most likely, developers will not initiate these projects if there is no guarantee they will have access to terrorism insurance through the period of construction -- and, thereafter, until after the expiration of the five-plus years of the statutes of repose governing design and construction design flaws.

Need for Additional Capacity:

I want to discuss one other major challenge today faced by large-scale projects in high risk areas -- the shortage of capacity. All over New York City, real estate owners and developers are struggling to obtain and maintain sufficient terrorism insurance. I spoke to one major owner whose lower Manhattan portfolio is worth roughly $10 Billion, but who has been unable to obtain more than $1 Billion of terrorism coverage. Another company was forced to delay a multi-hundred million dollar development while their businesspeople traveled to Europe, Asia and other foreign markets seeking to secure terrorism coverage. This shortfall in the terrorism coverage available here – which continues even though the TRIA program is in place -- is causing a wide variety of legal and business problems for these owner and many others like them.

The project I oversee for Silverstein – the World Trade Center rebuilding – provides a clear example. The World Trade Center will cost in the range of $13-$15 billion in total, including the four office towers, PATH Hub, the Memorial and all the infrastructure to serve this new district. But according to the leading insurance consultants and brokers in New York City, even with the current TRIA extension in

place there is now less than $750 million worth of coverage available in the entire lower Manhattan market.

We strongly believe that a TRIA extension ought to address the capacity problem of densely developed urban areas branded as "high risk" by the insurance industry -- for example, lower Manhattan, Times Square and the Grand Central Station area. Today you are hearing from Mayor Bloomberg and several others, including Steve Green, one of the very largest owners in the City, about the need to address the problems of the current TRIEA relating to certified and non-certified acts – the foreign versus domestic distinction -- and so-called NBCR events. These proposed general "fixes" to TRIA are badly needed in order to free up terrorism insurance capacity. However, even if these important corrections are made there will *still* be questions about whether the incentives will be sufficient to attract more capacity to certain areas perceived as "high risk." Therefore, we suggest that consideration be given to additional actions – for example, (a) reducing the current "deductible retention" applicable to insurers under the current TRIEA for policies written to cover projects in areas that have previously experienced acts of terrorism or are otherwise judged "high-risk," and/or (b) reducing the current $100 million TRIEA program trigger. We are not absolutely wedded to any particular mechanism. But we do need this committee's leadership and creativity to find a way to assure that terrorism insurance is available to Midtown and lower Manhattan and other areas like them, where there is now a significant capacity shortfall. Obviously, it would be a great disappointment to everyone involved with the TRIA program if the redevelopment of the World Trade Center were seriously hindered by an inability to obtain terrorism insurance.

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There is one other step Congress can take in order to free up terrorism insurance capacity. We also urge that a TRIA extension clarify the scope of TRIA coverage by making it clear that TRIA is a backstop for *all* proximate consequences of a terrorist attack, including a fire or collapse following an attack – as well as damages from the initial impact or explosion. Unfortunately, the scope of TRIA coverage is currently somewhat unclear, and therefore terrorism risk is bleeding into non-terrorism builder's risk and property insurances and causing a shortage of capacity for those coverages – especially in certain highly concentrated, "high-risk" areas like lower Manhattan.

Conclusion:

The TRIA program is essential to give projects any chance of obtaining the terrorism insurance which lenders and investors will require. It has been a success and it should be made permanent. However, according to our insurance professionals, it would not now be possible, even with the TRIA extension in place – to adequately insure even *one* of the four office buildings now planned for construction on the World Trade Center site. Also, this doesn't account for the terrorism insurance needs of several other office buildings and a major transportation hub being constructed nearby – which will all have the effect of lessening capacity even further. In order to assure that commercial development thrives in our major urban centers, it is critical that the Government continue to work with the private sector to develop a long-term, workable solution, including some adjustments to the TRIA program designed to increase terrorism risk insurance capacity in high risk areas.

Thank you again for allowing us to participate today.

Independent Insurance Agents
& Brokers of America, Inc.

STATEMENT OF THE
INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA

COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

UNITED STATES HOUSE OF REPRESENTATIVES

March 5, 2007

Chairman Kanjorski, Ranking Member Pryce, and members of the Subcommittee, the Independent Insurance Agents and Brokers of America (IIABA) is pleased to have the opportunity to present our association's perspective on terrorism insurance.

IIABA is the nation's oldest and largest trade association of independent insurance agents and brokers, representing a network of more than 300,000 agents, brokers, and employees nationwide. IIABA represents small, medium, and large businesses that offer consumers a choice of policies from a variety of insurance companies. Independent agents and brokers offer a variety of insurance products -- property, casualty, health, life, employee benefit plans and retirement products -- and sell nearly 80 percent of all commercial lines policies in the country. Members of the Big "I", as we are known, write the coverage for America's businesses and serve as the conduit between consumers and insurance companies, and therefore we understand the capabilities and challenges of the insurance market. From this unique perspective, we urge Congress to develop a long-term solution for terrorism insurance that enables the private sector to serve consumers and that limits federal intervention and protects taxpayers.

We must begin by complimenting Chairman Frank, Chairman Kanjorski, Ranking Member Pryce and all of the Members of this Committee and Congress for recognizing the importance of a federal role in terrorism insurance and enacting the Terrorism Risk Insurance Extension Act (TRIEA) of 2005. This extension Act and the original law, the Terrorism Risk Insurance Act (TRIA) of 2002,

have worked to ensure that terrorism insurance is available and more affordable, protecting our nation's economic security.

We applaud you for holding today's hearing to examine the future of terrorism insurance. Clearly, the leadership of this Committee understands that the insurance market's ability to protect the American economy from the financial consequences of terrorism risk is a critical component of our national security and vitality during the ongoing war on terror. Your efforts are crucial to finding long-term solutions for the economic and physical risks associated with terrorism, and we thank you for your continued leadership.

Background

It is well known that the insurance community performed admirably in the immediate aftermath of September 11th, 2001, honoring its commitment and providing resources needed to quickly and fully pay claims and thus playing a pivotal role in the recovery-and-rebuilding process. However, even though the insurance marketplace responded effectively to the 9/11 losses, it was quickly apparent, and remains so today, that insurers could not handle the risk of further large-scale terrorist events without a federal backstop.

Not unexpectedly, insurers reacted in late 2001 and 2002 to the new perception of exposure and lack of scientific terrorism modeling with exclusion clauses and outright cancellations of coverage. This left agents and brokers in the always difficult position of being unable to meet consumers' needs for coverage. But beyond our own professional dilemma, it quickly became clear that the absence of coverage presented an immediate threat to our country's economy that had to be addressed – construction and other important economic activity were being impacted by the lack of coverage.

Fortunately, through the leadership of the Administration and many in Congress, particularly in this Committee, the government did respond to address problems in the marketplace with TRIA. Those of us in the market, however, do not need to be reminded of how acute the problem was before Congress and the President enacted the Terrorism Risk Insurance Act in late 2002. Economic activity, especially significant new construction projects, was beginning to be impacted by the inability of owners to satisfy demands of current or prospective lenders to demonstrate adequate insurance coverage. Fortunately, TRIA was put in place before the worst effects of this availability and affordability crisis further injured our national economy.

However, as TRIA neared expiration at the end of 2005, many insurance policies covering businesses of all sizes and types extended past the program's December 31, 2005, sunset date. Because state insurance regulators approved conditional terrorism exclusions in most states to protect insurance company solvency after TRIA, there were continued concerns that policyholders could again face potentially harmful gaps in coverage as the Act expired. With the risk of catastrophic attacks on U.S. soil still very real, and the capability of both insurers and reinsurers to offer comprehensive terrorism coverage for an uninsurable risk still very limited, Congress wisely passed TRIEA, which provided a two-year extension of the federal backstop under TRIA with some modifications to encourage the private sector to take on additional risk.

The current public-private partnership created by TRIA, and extended in TRIEA, has worked well and generally as intended, al[illegible] businesses across America to contin[illegible]g and growing, and preserving jobs in the proce[illegible] and TRIEA have saved our econo[illegible] of dollars by

making terrorism insurance broadly available to all businesses that want and need this coverage at virtually no cost to the federal government. Prices have come down, capacity has grown, and demand is up in many geographic areas.

Unfortunately, the program is scheduled to expire at the end of this year, and there is no reason to believe that the threat of terrorism is on the decline, or that the private insurance markets alone can adequately meet our nation's need for coverage. As such, IIABA encourages Congress to develop a long-term solution to this problem, and we applaud the Committee for holding this hearing to explore these important issues.

Post-TRIA Availability of Terrorism Risk Insurance

Although potential terrorism losses in the United States have been estimated at over $100 billion, current reinsurance capacity is only estimated at $6 to 8 billion.[1] As former Federal Reserve Chairman Alan Greenspan and other notable experts have asserted, the private insurance market is simply not in a position to handle the unpredictable nature and possible immense size and scope of terrorist attacks.[2] Despite the warnings of these experts, a specific plan for developing a private reinsurance mechanism to spread catastrophic risk from terrorism has yet to emerge.[3] Now is the time to develop a long-term public-private partnership.

The original enactment of TRIA in 2002 and its extension in 2005 have been successful in stabilizing the insurance marketplace and have helped eliminate the market disruptions and uncertainties that were witnessed in the immediate wake of September 11th. A failure to reauthorize the federal program could have meant economic hardship for countless small and large communities across this country and would have had an especially devastating impact on financial and commercial centers, such as New York. As a result of the enactment of TRIA and TRIEA, our members are currently able to offer consumers options with respect to terrorism coverage.

However, months before the extension of TRIA in December 2005, these interested policyholders were concerned that exclusions and sunset clauses would eliminate their coverage as insurers prepared for the termination of the TRIA backstop. Although TRIA was extended, these policyholders – including small and mid-sized businesses – continue to worry about the impact of terrorist events in this country and their access to insurance coverage to help them get back on their feet should another event occur. This concern is evident in the increased take-up rates for terrorism insurance as consumer demand for terrorism insurance continues to grow.

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[1] *See* Franklin W. Nutter, President, Reinsurance Association of America, Testimony at the Public Hearing of the Terrorism Insurance Implementation Working Group of the National Association of Insurance Commissioners 5-6 (Mar. 29, 2006), *available at* http://www.naic.org/documents/topics_tria_testimony0603_RAA.pdf. Some industry representatives, however, fear that capacity is much smaller. *See* Warren W. Heck, Chairman and CEO, Greater New York Mutual Insurance Company, Testimony at the Public Hearing of the Terrorism Insurance Implementation Working Group of the National Association of Insurance Commissioners 4 (Mar. 29, 2006), *available at* http://www.naic.org/documents/topics_tria_testimony0603_NY_Mutual.pdf.

[2] *Greater N.Y. Mutual CEO Makes Case for Terror Coverage*, Insurance Journal, July 27, 2005.

[3] In fact, the Department of Treasury's (Treasury) June 30, 2005 report to Congress concerning the terrorism risk insurance program did not analyze this problem. *See* U.S. Dep't. of Treasury Office of Economic Policy, *Report to Congress: Assessment: The Terrorism Risk Insurance Act of 2002* 5 (June 30, 2005).

We would like to stress that the interest in, and the need for, a terrorism insurance backstop is NOT confined solely to large urban areas or to large businesses. IIABA represents agents and brokers selling coverage to consumers across the country. Our collective experience establishes that terrorism insurance coverage is not just a 'big city' or a 'big business' problem. It is a business customer problem throughout the country; this is truly a national issue. As take-up rates have gone up across the country, we have seen terrorism coverage purchased by a wide and diverse variety of interests, from small towns in Mississippi to small and large businesses in New York City. As the intermediaries between those customers and the insurers, our members remain concerned that the needs of many policyholders will not be met with affordable and good quality coverage for this peril if there is no terrorism insurance program in place after December 31, 2007.

Long-term Availability and Affordability of Terrorism Risk Insurance Coverage

In addition to the potential magnitude of losses from a future terrorist attack, a number of other factors will determine the long-term availability and affordability of terrorism risk insurance coverage, including: (1) the ability to accurately predict the severity and, most importantly, the frequency of terrorism given the increased threat; (2) the effectiveness of mitigation efforts; (3) the insurance market's capacity for substantial catastrophic losses combined with policyholder take-up rates for terrorism coverage; and (4) whether or not insurers are required to "make available" coverage for terrorism risk. Although most of these factors are considered in the context of many types of perils, their impact on the availability and affordability of terrorism is unique due to the nature of terrorism risk.

While modeling has shown us that the size and severity of a terrorist attack could easily threaten the capacity of the insurance market, the risk cannot be assessed in traditional ways. Insurers lack confidence in modeling terrorism risk due to the lack of past statistical records for such risk.[4] Unlike other types of catastrophic risks, insurers and actuaries know very little about where or when terrorism might occur; how it might occur; how often it might occur; or the nature, effects, and costs of such an attack. Much of the information that does exist is available only to governmental agencies that fiercely guard it for security and law enforcement reasons. As a result, underwriters shied away from terrorism risk before the creation of the TRIA backstop. Indeed, since the enactment of TRIA, insurers have proven unable to introduce wide-ranging, new products for insuring terrorism risk. There is currently no indication that the ability to accurately predict and underwrite terrorism risk will improve significantly in the future and certainly not before the Act's expiration at the end of this year.

The unpredictable nature of terrorism also hinders the ability of the consumers who agents and brokers serve to effectively mitigate against acts of terrorism. Although policyholders may invest in increased security measures to thwart the efforts of terrorists, the effectiveness of these measures is limited due to the proven adaptability of terrorists. Moreover, the incentives offered by insurers frequently fail to match the expense of such measures.

[4] *See* Letter from Dennis Fasking, Chairman, Extreme Events Committee, American Academy of Actuaries, to Rep. Richard Baker, Chairman, Subcommittee on Capital Markets, U.S. House of Representatives (August [illegible] 5), *available at* http://www.actuary.org/pdf/casualty/tria_080205.pdf.

Notwithstanding the gap between potential losses and available capacity, policyholder take-up rates for terrorism risk insurance coverage have increased since the enactment of TRIA.[5] Increased take-up rates translate into greater capacity to cover losses and spread risk, in addition to reducing taxpayer exposure to post-event and ad-hoc government funding. Likewise, as capacity grows, policyholder take-up rates should continue to increase.

While our members remain opposed to federal intervention in the insurance market in general, they nevertheless acknowledge that the terrorism risk insurance coverage currently available to the policyholders whom they serve would not exist without TRIA. This is a clear case of marketplace failure, and in those rare instances, limited federal involvement in a reinsurance capacity is warranted. Once the backstop expires, the challenges discussed above will likely paralyze the private insurance market's ability to make terrorism risk insurance coverage available and affordable for policyholders. Federal legislation is necessary to ensure that policyholders continue to have access to such coverage.

Potential Solutions to Increase Private-Market Insurer and Reinsurer Capacity for Terrorism Risk

Any analysis of the long-term availability of terrorism risk insurance must acknowledge the unique nature of terrorism risk. Terrorist acts are nearly impossible to predict because they are intentional and heinous acts committed by those who wish to attack our country, our institutions, our livelihood, and our sense of security. Given the unique nature of terrorism risk, the insurance market has proven unable to make meaningful assessments or judgments about possible terrorist events.

Specifically, IIABA believes that a private-public partnership remains essential to the challenge of making terrorism risk insurance available after the expiration of the Act at the end of this year. Although some potential solutions might allow for the reduction of federal involvement in the years to come, it may be difficult to substantially reduce such a role in the immediate future without disrupting the market. Indeed, it will take decades for the industry to close the gap between the estimated $6 to 8 billion in current reinsurance capacity and potentially hundreds of billions of dollars in losses from a terrorist attack.[6] As such, public participation is necessary to encourage private markets to get in and stay in the business of insuring terrorism risk.[7]

The creation of an effective and long-term mechanism is essential for managing the risk posed by terrorist events. Without some form of meaningful solution, terrorism coverage will be extremely difficult – if not impossible – for most to obtain after December 31, 2007, and, as noted above, the

[5]A survey conducted by the Mortgage Bankers' Association and reports by the RAND Center for Terrorism Risk Management and Marsh suggests that policyholder take-up rates have increased since the enactment of TRIA. *See* Survey: Lack of Terror Coverage Would Hurt Commercial Mortgage Market, *Insurance Journal*, June 8, 2004; Peter Chalk et al., *Trends on Terrorism: Threats to the United States and the Future of the Terrorism Risk Act* 8 (RAND Center for Terrorism Risk Management Policy 2005), *available at* http://www.rand.org/pubs/monographs/2005/RAND_MG393.pdf; Marsh, *Marketwatch: Terrorism Insurance 2005* 6-14 (2005), *available at* http://www.marsh.dk/files/Marketwatch_Terrorism_Insurance_2005.pdf.

[6] *See* Marsh, *Marketwatch: Terrorism Insurance 2005* 33 (2005), *available at* http://www.marsh.dk/files/Marketwatch_Terrorism_Insurance_2005.pdf.

[7] Countries such as the U.K., France and Spain, which have a longer history of protecting against terrorist threats, have long accepted that government must play a role in insuring against terrorism losses.

impact will likely be felt before then. Such an outcome would be especially troubling for small and medium-sized businesses, which are already challenged by the current environment and are not in a position to self-insure. The vast majority of businesses in this country are of this size, and the nonexistence of some form of a terrorism insurance program could have devastating effects on the national economy. For these reasons, IIABA urges Congress to continue analyzing long-term strategies before the expiration of the federal backstop next year.

Insurance Coverage for NBCR Events

We believe that any long-term solution to protect the nation's economy in the face of substantial terrorism losses must address potential losses from nuclear, biological, chemical or radiological (NBCR) events. Other than coverage included in statutorily mandated lines (e.g., workers compensation), little coverage is available for NBCR events. Although NBCR losses are perhaps the most catastrophic types of terrorist attacks, coverage for these types of losses is currently excluded from most existing terrorism risk insurance coverage.

The American Academy of Actuaries (AAA) recently estimated that insured losses from a conventional truck bomb attack, as well as medium and large NBCR events caused by terrorism, could reach $778 billion in New York City.[8] The AAA estimated that losses in four U.S. cities could reach the following levels:[9]

	Losses from a Truck Bomb Attack	Losses from a Medium NBCR Event	Losses from a Large NBCR Event
New York City	$11.8 billion	446.5 billion	$778 billion
Washington, D.C.	$5.5 billion	$106.2 billion	$196.8 billion
San Francisco	$8.8 billion	$92.2 billion	$171.2 billion
Des Moines	$3 billion	$27.3 billion	$42.3 billion

The difficulties of developing adequate capacity to cover terrorism losses due to terrorism and diversifying risk are aggravated in the context of NBCR events. Currently, there is essentially no reinsurance capacity for NBCR losses. NBCR terrorism risk is even more difficult to predict and underwrite than non-NBCR terrorism risk. Moreover, as discussed during the NAIC Terrorism Insurance Implementation Working Group's public hearing on terrorism insurance availability last year, it could take many years to quantify the damages from a NBCR attack.

During our participation in the development and extension of TRIA, IIABA supported mandatory availability of insurance coverage for both conventional and NBCR losses. Based on our experience in the market, we know that policyholders desire a long-term solution to the availability of terrorism risk insurance, including coverage for NBCR events. Policyholders want certainty for their business planning and operations, and they clearly do not want to be subject to on-again, off-again terrorism insurance mechanisms, and exclusions for NBCR losses. Terrorism is perhaps the greatest

[8] *See* Emily Crane, IIABA, *The Potential Costs of Terrorism*, Insurance News & Views, Apr. 6, 20[illegible] *[illegible]ailable at* http://w[illegible]w.iiaba.net/IAMag/NewsViews/040606.html.

[9] *Id.*

threat to our nation's economic future, and we believe that the reality of potentially large losses from NBCR events must be addressed to protect our economy, as well as policyholders and taxpayers.

Given the potential magnitude of NBCR losses, a catastrophic attack in a line not covered under the TRIA program (e.g., NBCR) would almost certainly lead to a substantial government bailout. In light of the potentially enormous burden that taxpayers could face as a result of NBCR risk, it is imperative that policymakers work to help develop the private insurance market's capacity for losses. As demonstrated with non-NBCR coverage under TRIA, we do not expect the private insurance market to view NBCR risks as insurable or move toward developing capacity to cover such risks without encouragement from the federal government. Public participation is a vital requirement for any long-term solution for increasing private market capacity to cover these types of events. We commend the Committee for recognizing the unique NBCR risks by including the NBCR make available provision in the House-passed TRIA extension, H.R. 4314, in 2005.

Nationwide Need for Terrorism Risk Insurance

In addition to the capacity problem, we believe that insurers' ability to diversify risk will also pose challenges to the long-term availability and affordability of terrorism insurance. The nature of the risk presented by terrorism requires that any long-term solution enable the market to spread the risks associated with terrorism and develop as broad a funding base as possible. This means focusing on increasing take-up rates in all communities, which is closely related to the availability and affordability of coverage. As former Washington, D.C. Insurance Commissioner Larry Mirel noted in Congressional testimony, businesses in New York City, Washington, and other prominent "target" areas pay very high premiums for terrorism coverage – even with the existence of the federal program – yet they are not the true targets of terrorists.[11] Terrorists, as the Commissioner noted, want to attack America, and an attack on any particular town or city is actually an attack on our nation as a whole.[12] Accordingly, it is both appropriate and fair for policymakers to identify solutions that truly help protect America's national economy and identity through a wide spreading of this distinctive risk.

Domestic v. International Terrorism

Although domestic terrorism is excluded from the current federal terrorism risk insurance program, we would recommend that any long-term response eliminate the distinction between domestic and international terrorism. Domestic terrorism, which presents many of the same characteristics of international terrorism, is a very serious threat and coverage for this risk is largely unobtainable in the marketplace today. IIABA believes that such distinctions are likely to prove irresolvable in the aftermath of an attack. Distinguishing between domestic and international terrorism can be difficult (if not impossible) as the anthrax incidents of 2001 and the London Underground bombings of last summer demonstrated. In short, IIABA continues to believe that the terrorism peril should be treated on a seamless basis without such distinctions, as it was treated in H.R. 4314 in 2005.

[11] The Future of Terrorism Risk Insurance: Hearing Before the Subcomm. on Markets, Insurance and Government Sponsored Enterprise of the H. Financial Services Comm. 3 (July, 27, 2005) (statement of Laurence H. Mirel, Commissioner, District of Columbia Department of Insurance, Securities and Banking, Testimony before the House Financial Services Committee); *available at* http://financialservices.house.gov/media/pdf/072705lm.pdf.

[12] *Id.*

Conclusion

IIABA applauds Congress for not ending TRIA abruptly in 2005 and for passing a two year extension, TRIEA. Although it seems the terrorism insurance program was only recently extended, it is time to start looking ahead, and we thank the Committee for beginning this process today. The need for action is actually more urgent than many might realize, as policyholders are renewing policies with contract terms that extend beyond December 31, 2007. If a solution is not in place early this year, insurance markets may once again face significant disruption and uncertainty, and we anticipate that insurers would exclude terrorism risks from policies where authorized.

We also hope that any solution will draw on the experiences of the current program in order to assist the private markets in handling this risk. For example, despite the fact that TRIA does backstop losses arising from NBCR attacks, commercial customers generally are unable to get that type of coverage in the market today.

IIABA members, along with many in the insurer and policyholder community, recognize that we must find a long-term solution to our nation's terrorism insurance problem and are committed to this process. We look forward to working with Congress on this matter that is crucial to our country's economic security.

National A sociation of Pr fe ional Insuranc Ag nts

Terrorism Insurance Field Hearing
March 5, 2007
New York, New York
Statement to the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises of the House Financial Services Committee

Thank you for the opportunity to share the concerns of the members of the National Association of Professional Insurance Agents (PIA) regarding terrorism insurance. PIA represents approximately 11,000 agency owner-principals of independent insurance agencies across the United States.

Our statement will address our basic concerns and thoughts for a long-term solution to insuring for possible terrorist threats as well as personal testimony from PIA members as to the situations they face each day and why terrorism insurance is so important to their daily business.

PIA supports the creation of a long-term mechanism for terrorism coverage to ensure the viability of the existing domestic insurance market. Terrorism insurance is an important part of the nation's economic safety net because it allows insurers to manage terrorism risk in a cost effective manner. PIA believes that legislation must be passed well before the December 31, 2007 expiration of the Terrorism Risk Extension Act of 2005 because insurance companies are evaluating policy renewals now. We applaud the Subcommittee for holding hearings early in the year in order to pass effective legislation well before the year's end.

NBCR Enhancements

An important component to include in terrorism insurance legislation is the expansion of nuclear, biological, chemical and radiation (NBCR) coverage. Attacks of this nature must be addressed because the severe magnitude cannot be absorbed by the insurance industry without federal participation.

PIA encourages Members of Congress to set the trigger level for a federal backstop at a level that allows small company participation in the program, not just cover large insurers.

Terrorist attacks do not target specific businesses or industries. Rather, they are directed at the U.S. government and the nation's entire economic system. Likewise, terrorist attacks do not target specific geographic regions. Below are statements from Professional Insurance Agents across the country who rely on TRIA in order to serve policyholders in their communities. Therefore, it remains critical that Congress and the federal government continue to work with the insurance industry to ensure that terrorism insurance remains available and affordable for consumers and American businesses.

Acts of terrorism continue to pose an unprecedented challenge for the insurance industry. It remains difficult, if not impossible, for underwriters to accurately determine premiums based on

sound actuarial calculations. Insurers are unable to accurately predict the frequency or severity of loss to effectively spread risk.

TRIA is an important part of the nation's economic safety net because it allows insurers and commercial insurance buyers to manage terrorism risks in a cost-effective manner. Without TRIA's financial backstop in place, the federal government would be left to cover the short-term and long-term costs associated with terrorist attacks.

A report commissioned by the American Insurance Association, the National Association of Mutual Insurance Companies, The National Council on Compensation Insurance, the Property Casualty Insurers Association of America, the Reinsurance Association of America, and the Financial Services Roundtable, concludes that even absent another major terrorist attack, the economic drag produced by a lack of a federal terrorism insurance backstop would have severe consequences. "U.S. gross domestic product (GDP) may be $53 billion (0.4%) lower, household net worth may be $512 billion (0.9%) lower and roughly 326,000 (0.2%) fewer jobs may be created." The report is the work of a widely respected research organization, the Analysis Group, Inc. Among the conclusions of the report is the observation that, without TRIA, "an attack roughly the size of the 9/11 attacks would mean the loss of tens of thousands of jobs due to reduced insurance coverage. In addition, thousands of additional commercial bankruptcies could ensue."

TRIA is Not Just a "New York State of Mind:"

Insuring against terrorist attacks is not just a "New York state of mind." An inaccurate perception has developed that TRIA primarily benefits large businesses in major urban areas, especially in the Northeast. To the contrary, the need for TRIA is not confined to any one city, state or region of the country. Terrorism coverage is being required more and more by lenders of their commercial insurance borrowers, on any sizable commercial loan anywhere. Having this coverage available and affordable for small and mid-size commercial insureds—the customers of PIA agencies throughout the United States—is critical.

PIA insurance agents across the country have reported compelling examples of the continuing need for terrorism insurance coverage in communities of all sizes. Businesses and individuals in areas as diverse as Memphis, Tennessee; Cincinnatti, Ohio; as well as rural areas of Louisiana and Mississippi have all experienced this need, as reported by members of our Association.

For example, a client of a PIA member purchased a medium sized shopping center in Memphis, Tennessee. The mortgagee would not make the loan unless the insured has terrorism coverage.

An independent insurance agent in Ohio said, "Please let our Members of Congress know that they need to renew TRIA, so that my insurance clients in Ohio can obtain affordable terrorism insurance coverage. Without TRIA, they will be left unprotected and our local economy will suffer."

Another PIA insurance agent who owns an agency in South Louisiana no[illegible] busin[illegible] serves the insuring needs of the petrochemical industry, a major sector in [illegible] on[illegible] t

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has been identified as a potential target of terrorist attacks. As a result, many of the small-to-mid-size businesses insureds that serve the needs of the petrochemical industry continue to require terrorism coverage. The ability of these firms to continue in business depends on both the availability and affordability of terrorism/TRIA coverage.

A number of businesses in central Mississippi are required to have terrorism coverage as a part of their business insurance. There, a number of contractors that work for the gaming industry are required to have such coverage, as are long-haul truckers carrying hazardous cargo. The economic impact of failing to renew TRIA beyond the present sunset could have devastating consequences on a large number of businesses.

Conclusion:

The independent insurance agents who are members of the National Association of Professional Insurance Agents need a viable insurance marketplace in order to provide their customers with terrorism insurance coverage options that are affordable. We commend Congress for realizing that there is an ongoing need for a more permanent solution to insuring against terrorist attacks, and that this is not a task that the private market can handle on its own, either now or in the forseeable future.

Our Association was founed in 1931. As a result, our association has previous experience with the issue of insurance during times of war. Our archives detail how, following the attack on Pearl Harbor on December 7, 1941, one of our clients' major concerns was obtaining affordable insurance that would cover war risks. In 1942, Congress responded by creating a backstop program for war risk insurance that remained in effect until 1947, assuring that the clients of PIA agencies has the coverage they needed.

Today, the United States is engaged in a protracted War on Terror, which many say poses an even greater risk. As a nation, we cannot fail to act to assure that this risk can be insured. We must not do less now than we did during World War Two.

We urge this Committee to move without delay to pass legislation that enables the continued availability of terrorism insurance coverage, either on a multi-year or permanent basis.

Thank you very much.

LOOKING BEYOND TRIA:
A CLINICAL EXAMINATION OF POTENTIAL TERRORISM LOSS SHARING

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This paper is partially based on a larger study *TRIA and Beyond: Terrorism Risk Financing in the US*, undertaken by the Wharton Risk Management and Decision Processes Center. We thank Jeff Brown, Neil Doherty, Marty Feldstein, Esther Goldsmith, Scott Harrington, Paul Kleindorfer, Mark Pauly, Irv Rosenthal Peter Schmeidler and Kent Smetters, as well as participants in the 2006 NBER Summer Institute on the Economics of National Security for insightful comments on different aspects of the analyses provided here. The usual disclaimer applies.

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ABSTRACT

The Terrorism Risk Insurance Act of 2002 (TRIA) established a public-private program to cover commercial enterprises against foreign terrorism on US soil. It was a temporary measure to increase the availability of risk coverage for terrorist acts by requiring insurers to provide coverage. Initially established to sunset on December 31, 2005, a two-year extension has been voted by Congress and signed by the President in December.

This paper provides an extensive series of empirical analyses of loss sharing under this program in 2005, and a prospective analysis for 2006. Using data collected on the top 451 insurers operating in the United States, we examine the impact of TRIA on loss sharing between the key stakeholders: victims, insurers and their policyholders, and the taxpayers. By simulating the explosion of a 5-ton truck bomb in major cities in the United States, we conclude that taxpayers are likely not to pay anything for losses below $15 billion. For a $25 billion loss, insurers and policyholders would handle between 80 and 100 percent of the loss depending on the property take up rate. Only for terrorist attacks where insured losses were $100 billion would taxpayers have to pay 50 percent of the claims. Recent modifications of TRIA will transfer an even larger part of the risk to the private sector.

We also show that if TRIA were made permanent in its current form some very large insurers could strategize by collecting large amount of premiums for terrorism insurance but only would be financially responsible for a small portion of the claims. Commercial policyholders from all insurers (whether or not covered against terrorism) and the federal government would absorb the residual insured losses, raising equity issues. How significant this strategy might be will depend on several aspects, including market shares and the loss-sharing design under the permanent program. The paper also reviews a set of possible long-term alternatives or complementary options to the current design of TRIA that could be important features of a more permanent program.

We conclude that more than five years after 9/11, the question as to who should pay for the economic consequences of a terrorist attack on the US has not yet received the attention it deserves. Congress or the White House should consider establishing a national commission on terrorism risk coverage before permanent legislation is enacted.

Key words: Economics of National Security; Terrorism; TRIA; TRIEA; Catastrophe Risk Insurance; Optimal Risk Sharing

JEL No. H56, G22, G28

1. Introduction

The evolution of international terrorism is now well accepted. Still mainly organized as local political actions twenty years ago, it has continuously expanded to include a large portion of extremist religious and other groups seeking to inflict fear, mass-casualties and maximum disruption to western nations' social and economic continuity and operating internationally[2]. Indeed, the world's 14 worst terrorist attacks (based on the number of casualties) all occurred after 1982, more than three-quarter of which took place between 1993 and 2004. A large portion of all terrorist attacks in the world during this period have been directed against U.S.-related interests and personnel. The Madrid train bombings on March 11, 2004, the coordinated London bus and underground bombings of July 7, 2005, and the bombings in Amman, Jordan in November 2005 -- attacks against three countries that were allies of the United States in the war in Iraq -- suggest that the United States remains a principal target for several international terrorist groups adhering to al-Qaeda's ideology.

Although the U.S. has been successful since 9/11 in preventing terrorist attacks on its own soil, the impact to the economy of another mega-attack or series of coordinated attacks serious concerns the government, the private sector and citizenry (Kunreuther and Michel-Kerjan, 2004 and 2005)[3]. With security reinforced around federal buildings, the commercial sector constitutes a softer target for terrorist groups to inflict mass-casualties and stress on the nation. These threats require that the country as a whole develop strategies to prepare for and recover from a (mega-)terrorist attack. Insurance is an important policy tool for consideration in this regard.

Quite surprisingly, even after the terrorist attack on the World Trade Center in 1993 and the Oklahoma City bombing in 1995, insurers in the United States did not view either international or domestic terrorism as a risk that should be explicitly considered when pricing their commercial insurance policy, principally because losses from terrorism had historically been small and, to a large degree, uncorrelated. Thus, prior to September 11, 2001, terrorism coverage in the United States was an unnamed peril included in most standard all-risk commercial and homeowners' policies covering damage to property and contents.

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[2] Enders, W. and Sandler, T. (2006), *The Political Economy of Terrorism*, Cambridge University Press.

[3] Kunreuther, H. and Michel-Kerjan, E. (2004), "Challenges for Terrorism Risk Insurance in the United States", *Journal of Economic Perspectives*, Fall 2004, 18 (4), pp 201-214.

Kunreuther, H. and Michel-Kerjan, E. (2005), *Insurability of (mega)-Terrorism*, Report for the OECD Task Force on Terrorism Insurance, in OECD (2005), *Terrorism Insurance in OECD Countries*, Paris: Organization for Economic Cooperation and Development, July 5.

The terrorist attacks of September 11, 2001, killed over 3,000 people from over 90 countries and inflicted insured losses currently estimated at $32.5 billion that was shared by nearly 150 insurers and reinsurers worldwide. Reinsurers (most of them European) were financially responsible for the bulk of these losses. These reinsurance payments came in the wake of outlays triggered by a series of catastrophic natural disasters over the past decade and portfolio losses due to stock market declines. Having their capital base severely hit, most reinsurers decided to reduce their terrorism coverage drastically or even to stop covering this risk.

Hence, in the immediate aftermath of September 11, 2001, U.S. insurers found themselves with significant amounts of terrorism exposure from their existing portfolio with limited possibilities of obtaining reinsurance to reduce the losses from a future attack. The lack of availability of terrorism insurance soon after the 9/11 attacks led to a call from some private sector groups for federal intervention. For example, the U.S. Government Accountability Office (GAO, formally General Accounting Office) reported in 2002 that the construction and real estate industries claimed that the lack of available terrorism coverage delayed or prevented several projects from going forward because of concerns by lenders or investors (U.S. GAO, 2002)[4].

In response to such concerns, the Terrorism Risk Insurance Act of 2002 (TRIA) was passed by Congress and signed into law by President Bush on November 26, 2002[5]. It constitutes a temporary measure to increase the availability of risk coverage for terrorist acts[6]. TRIA is based on risk sharing between the insurance industry and the federal government. While today it is unclear what type of long-term terrorism insurance program, if any, will emerge for dealing with the economic and social consequences of terrorist attacks[7], it is of prime importance to understand how different types of attack would translate into different loss.

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[4] U.S. General Accounting Office (GAO) (2002), "Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities." Testimony of Richard J. Hillman before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives, February 27.

[5] The complete version of the Act can be downloaded at: http://www.treas.gov/offices/domestic-finance/financial-institution/terrorism-insurance/claims_process/program.shtml

[6] U.S. Congress (2002). *Terrorism Risk Insurance Act of 2002*. HR 3210. Washington, DC, November 26.

[7] Works related to terrorism insurance in the U.S that were published in the last year (other than by the authors or cited elsewhere in the text) include Cummins, D. (2005), "Should the Government Provide Insurance for Catastrophes". Paper presented at the 30[th] Annual Economic Policy Conference, Federal Credit and Insurance Programs, Federal Reserve Bank of St. Louis, October 20-21; Jaffee, D. and Russell, T. (2005), "Should Governments Support the Private Terrorism Insurance Market?" WRIEC conference, Salt Lake City, August 2005; Jaffee, D. (2005), "The Role of Government in the Coverage of Terrorism Risks". Chapter 7 in OECD (2005), *Terrorism Risk Insurance in OECD Countries,* July 5; U.S. Department of Treasury (2005), *Assessment: The Terrorism Risk Insurance Act of 2002*, Washington, DC, June 30; Chalk, P. Hoffman, B., Reville, B. and Kasupski, A-B. (2005) *Trends in Terrorism*, Santa Monica, CA: RAND Corporation, June; U.S. Government Accountability Office (GAO) (2005), *Catastrophe Risks, U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks.* GAO-05-199, Washington, D.C., February 28; CBO (2005), *Federal Terrorism Reinsurance: An Update*, Washington, DC, January; Brown, J., Cummins, D, Lewis, C. and R. Wei (2004), "An Empirical Analysis of the Economic Impact of Federal Terrorism Reinsurance", *Journal of Monetary Economics* 51, pp. 861–898; Smetters, K. (2004), "Insuring Against Terrorism: The Policy Challenge," In Litan, R. and Herring, R. (e[illegible] *Brookings-Wharton Papers on Financial Services,* pp. 139-182.

This paper provides an extensive series of empirical analyses of loss sharing under the TRIA program for 2005 that was undertaken as part of a nine-person team research initiative we co-directed at the Wharton School last year, in collaboration with numerous firms in the insurance industry and other critical sectors, federal and international organizations that resulted in the Wharton Risk Center *TRIA and Beyond* report.[8] President Bush signed into law a two-year extension of TRIA on December 22, 2005, the Terrorism Risk Insurance Extension Act (TRIEA) that expanded the private sector role and reduced the federal share of compensation for terrorism insured losses. We also present some analyses for the years 2006 and 2007 based on the new loss-sharing design (See Appendix 2 for a side by side comparison TRIA 2005 vs. TRIEA).

The paper is organized as follows. The next section focuses on the loss sharing process between insurers, policyholders and taxpayers for 2005 and 2006. Using data collected on the top 451 insurers operating in the United States, Section 3 examines the impact of the deductible on insurers' losses from terrorist attacks and provides also a simulated analysis for the 30 largest insurers (70% of the market) for 2006 and 2007. Section 4 presents the financial impacts of terrorist attack simulations on the different stakeholders based on the explosion of a five-ton truck bomb or the crash of a commercial aircraft against one of the top 477 tallest high-rises of the country. Section 5 presents the results of a loss-share analysis for three major cities: Los Angeles (California), Houston (Texas) and New York City (New York) by combining the simulations with market share data for different line of insurance coverage in these cities. Section 6 provides a discussion as to how loss sharing between the relevant stakeholders is likely to evolve in 2006 and 2007.

In Section 7 we present a conceptual analysis as to what would happen if TRIA were made permanent. Using data on insurance markets up to 2005 (2006 data are not yet entirely available), we show that it would be possible for some very large insurers to game the system. They would collect large amounts of premiums for terrorism insurance but only be financially responsible for a small portion of the risk. Commercial policyholders from all insurers (whether or not they decided to purchase TRIA-like coverage or not) and the federal government will absorb the residual insured losses. Such strategizing raises important equity issues as to who should pay for terrorism losses[9]. We conclude the paper by reviewing a set of possible alternatives or complementary options to the current design of TRIA that could become important features of a permanent program.

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[8] This study undertaken in collaboration with numerous firms and federal bodies was designed to understand the importance of the insurance infrastructure in our national security agenda. For more details see the Wharton Risk Management and Decision Processes Center report *TRIA and Beyond*.

[9] Analyses in section 4, 5 and 7 focus on 2005, which is the most recent year data are available for. It will be possible for us to undertake similar analyses for 2006 later on this year.

2. Loss-Sharing Design

Eligibility for Coverage

Under both TRIA and TRIEA, insurers are obliged to offer terrorism coverage to all their commercially insured clients. Firms are not required to purchase this insurance unless mandated by state law, as is the case for workers' compensation lines in most states[10]. The stated coverage limits and deductibles must be the same as for losses from other events covered by the firm's current policy[11]. This implies that if there are restrictions on a standard commercial insurance policy, then terrorism coverage will also exclude losses from these events. Thus the risks related to a terrorist attack using chemical, biological, radiological and nuclear weapons (so-called CBRN) are covered under TRIA only if the primary policy includes such coverage[12].

Commercially insured losses are eligible for coverage under TRIA and TRIEA only if the event is certified by the Secretary of Treasury (in concurrence with the Attorney General and Secretary of State) as an "act of terrorism." As stated under TRIA an "act of terrorism" has to be "committed by an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the U.S. or to influence the policy or to affect the conduct of the U.S. Government by coercion" (TRIA, 2002). This distinction has been maintained under TRIEA. Therefore, an attack like the Oklahoma City bombing of 1995, which killed 168 people and had been the most damaging attack on domestic soil prior to 9/11, would not be covered under TRIA and TRIEA because it would be considered "domestic terrorism."[13] Under TRIA a condition for certification was that total losses from the attack must be greater than $5 million. TRIEA establishes a "per event trigger" for federal participation: aggregate insured losses must be at least $50 million from March 31, 2006 to January 1, 2007 and $100 million for losses occurring in the 2007 Program Year.

[10] Workers' compensation coverage is mandatory for a large majority of employers in all states other than Texas where it is optional. Employers must either purchase insurance or qualify to self-insure. Workers' compensation laws do not permit employers or insurers to exclude coverage for worker injuries caused by terrorism, including those caused by acts involving nuclear, biological and chemical agents.

[11] In most instances, this "make available" requirement means that insurers are required to offer a policy without a terrorism exclusion or limitation. Once an insurer has satisfied this offer requirement, the insurer is permitted to offer other terrorism coverage options, such as a policy with a sub-limit.

[12] The extension of TRIA based on Senate bill S. 467 directs the President's Working Group on Financial Markets to study long-term availability and affordability of coverage for terrorism losses, including (1) group life and (2) nuclear, biological, chemical and radiological events. The President's Working Group has to submit a report of its findings to the House Financial Services and Senate Banking Committees by September 30, 2006.

[13] The distinction between what would be a "certified" event covered by TRIA and a so-called "domestic" terrorist event may difficult to establish. For example, would attacks on the U.S. soil similar to the ones perpetrated in London on July 7, 2005 be considered domestic or international? We know today that some of the terrorists where British citizens who were trained to kill in Pakistan. The frontier between domestic and international might be a grey zone in a lot of cases.

While this paper focuses on commercial terrorism coverage, one should note that individuals at risk are also covered against terrorist attacks. Life insurance policies typically cover loss of life from terrorism attacks with the proceeds paid to the TRIA and TRIEA does not provide insurers with special protection against any of these individual risks (i.e., life, homeowners, automobile)[14].

Structure of the Partnership

Under TRIA's three-year term that ended on December 31, 2005, there was a specific risk-sharing arrangement between the federal government and insurers for a certified event. The same logic applies under TRIEA. Figure 1 depicts the public-private loss sharing for an insurer when total insured losses are less than $100 billion. If the loss suffered by an insurance company i is less than its deductible (ID_i), the insurer does not receive any reimbursement from the federal government. This situation is illustrated by an insured loss of L_1 in Figure 1 where the insurer's payment is represented by the oblique lines. If the insured loss due to a certified terrorist attack is greater then its deductible, as depicted by L_2 in Figure 1, the federal government will initially reimburse the insurer for 90 percent of the losses above its deductible, and the insurer will end up paying only 10 percent of it up front. The federal payment is represented by horizontal lines in the figure. This federal backstop provision is equivalent to free up front reinsurance above the deductible. As will be discussed later, the federal government will recoup part or all of this payment from all commercial policyholders.

The insurer's deductible is determined as a percentage of its total direct commercial property and casualty earned premiums of the preceding year for TRIA TRIEA lines (that is, lines covered by the act), and not just the premiums of clients that purchase terrorism coverage. In 2005 the premium was set at 15 percent -- if an attack had occurred in 2005, insurers would have been responsible for losses equal to 15 percent of the direct commercial property and casualty revenues that had been earned as premiums in 2004.[15] If an attack occurs in 2006, insurers will be responsible for losses equal to 17.5 percent of the direct commercial property and casualty earned premiums in 2005 (20 percent in 2007). This deductible plays a very important role in determining loss sharing between insurers and the federal government and can be very large for many insurers. Using data provided by A.M. Best on their estimates of TRIA retentions for major publicly held insurance companies for 2005, we determined this deductible to be

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[14] After initial discussions in 2002 about the possibility of having life insurance benefit from TRIA protection, Treasury decided not to extend TRIA to group life. It concluded that since insurers had continued to provide group life coverage after 9/11 even though the availability of reinsurance was reduced, there was no need to include this coverage as part of the TRIA program. Government Accountability Office (GAO) (2004), "Terrorism Insurance: Effects of the Terrorism Risk Insurance Act of 2002", GAO-04-806T, Washington, DC, May 18. Whether group life will be included in the future will mainly depend on the conclusion of the President's Working Group to be released by the end of September 2006. It is worth noting that the extension of TRIA reduces the spectrum of coverage; for example, TRIEA excludes commercial automobile insurance, burglary and theft insurance, surety insurance, professional liability insurance; and farm owners multiple peril insurance. [D&O insurance is still covered]

[15] In 2003 the deductible under TRIA was 7% of direct commercial property and casualty earned premiums the previous year and 10% in 2004.

\$3.6 billion for American International Group (AIG) and \$2.5 billion for St. Paul Travelers. Four other companies on the list of top 10 insurers, based on TRIA-line direct earned premiums had TRIA deductibles between \$800 million and \$2.1 billion in 2005. These are Zurich, Liberty, Chubb, and ACE. In the next section of the paper we provide an extensive analysis of this issue both for the Top 30 and Top 451 insurers in the U.S.

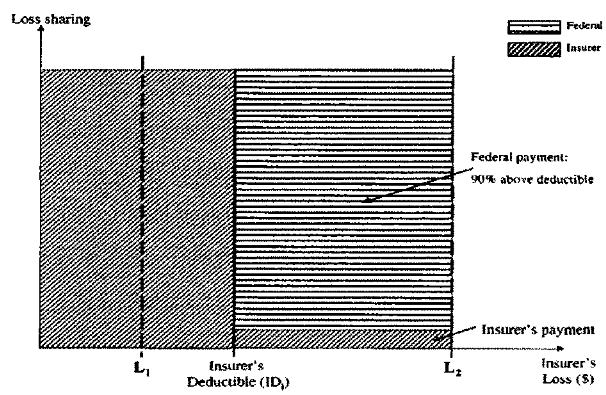

Figure 1. Loss-Sharing under TRIA and TRIEA Between an Insurer and the Federal Government
[Note: If the insurance company *(i)* loss is less than its deductible (ID_i), the insurer is not reimbursed by the government (e.g., for an insured loss of L_1). If the loss is greater than the deductible (L_2), the government reimburses the insurer for 90 percent of the losses above its deductible, and the insurer pays 10 percent.]

If the insurance industry suffers terrorism losses that require the government to cover a portion of companies' claims, then these outlays will be fully or partially recouped *ex post.* More specifically, the federal government will recoup the portion of its payment between the total insurers' outlays and a market aggregate retention amount, which is defined by the law (\$15 billion in 2005; \$25 billion in 2006; \$27.5 billion in 2007); that is called the "mandatory recoupment". This mandatory recoupment[16] is obtained by levying a surcharge on all commercially insured policyholders, whether they had purchased terrorism insurance or not. If the insured losses exceed \$100 billion during the year, then the U.S. Treasury will determine how the losses above this amount will be covered[17].

This federal recoupment surcharge "may not exceed, on an annual basis, the amount equal to 3 percent of the premium charged for property and casualty insurance

[16] The law is ambiguous as to what will happen if the total insurers' outlays are above this market aggregate retention.

[17] The TRIA legislation states that "If the aggregate insured losses exceed \$100,000,000,000, (i) the Secretary shall not make any payment under this title for any portion of the amount of such losses that exceeds \$100,000,000,000; and (ii) no insurer that has met its insurer deductible shall be liable for the payment of any portion of that amount that exceeds \$100,000,000,000. Congress shall determine the procedures for and the source of any payments for such excess insured losses." §103(e)(2 [illegible]. TRIEA does not modify this.

coverage under the policy."[18] Insurers play the role of intermediaries by levying this surcharge against all their property and casualty policyholders[19], whether or not they had purchased terrorism insurance, and transfer the collected funds to the Department of Treasury. In other words, taxpayers would have paid insured losses between $15 billion and $100 billion in 2005. In 2006, they will pay insured losses between 25 and 100 billion of dollars. The law indicates that the federal government could also recoup part of that payment (so-called "discretionary recoupment") but is not clear on that process; in this paper we assume that this is not the case.

Figure 2 depicts the repayment schedule in 2006 between the insurers (the area comprising blue oblique lines), all commercial policyholders (solid gray area) and the taxpayers (area comprising of horizontal lines) after the federal government has reimbursed all insurers for 90 percent of their claims payments above their deductible level (for those suffering loss above their TRIEA deductible). In the example we consider here, since the total insured losses L are greater than $25 billion but total payments by insurers are below the market aggregate retention of $25 billion, we assume the government recoups a portion of its payments from commercial policyholders with the remaining amount paid by U.S. taxpayers.

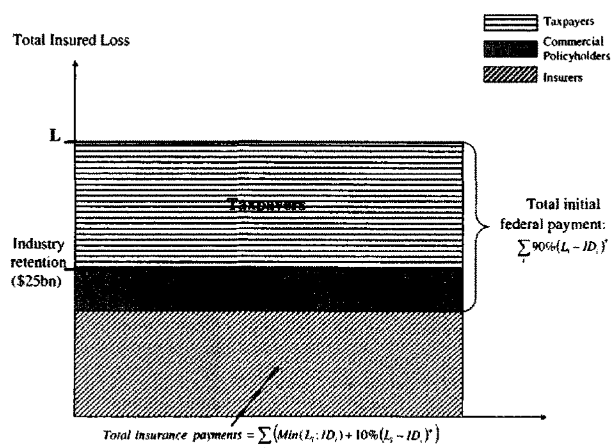

Figure 2. Loss Sharing under TRIEA between Insurance Industry, All Policyholders and Taxpayers in 2006

[Note: In this example, because the total insured loss L exceeds $25 billion, but total payments by insurers are below the market aggregate retention of $25 billion, we assume the government recoups a portion of its payments from commercial policyholders with the remaining amount paid by U.S. taxpayers.]

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[18] TRIA, Section 103(e)(8)(C).

[19] There is no statement in the legislation or its interpretation that specifically indicates that only the commercial policyholders are taxed. We have discussed this point with insurers and reinsurers. They have assumed that because TRIA applies only to commercial enterprises, the Department of Treasury will tax only commercial entities after a terrorist attack.

3. Empirical Analysis of Insurer Deductible/Surplus Ratios

We conducted a series of empirical analyses on the impact of TRIA and TRIEA on loss sharing between those directly targeted by a terrorist attack, their insurers and other interested parties such as commercial policyholders and U.S. taxpayers[20]. In this section and the next two others, we concentrate our analyses on the following two aspects: the effect of the program's deductible feature, and the effect of different terrorist attacks on losses and loss-sharing.

We first examined TRIA and TRIEA's deductible feature and its effect on the level of exposure to a terrorist attack insurers might have. We found that the larger an insurer's Deductible/Surplus (*D/S*) ratio, the more exposed the insurer is to losses from any given terrorist attack. We determined how the *D/S* ratio for the top 451 insurers operating in the country[21] has changed over the three years of TRIA's operation (2003-2005). Data necessary to do a similar analysis for 2006 (TRIEA line insurers' direct earned premiums) are not available yet. For that reason, we also computed the *D/S* ratios for 2006 and 2007 for the top 30 insurers under the deductible increases to 17.5 percent in 2006 and to 20 percent in 2007 but using extrapolated figures from the last three years. We then compared *D/S* over the five-year period 2003-2007 for each insurer (see Appendix 1).

We then analyzed in the next sections the impact of different simulated terrorist attacks on the losses experienced by the victims, insurers, policyholders, and taxpayers, and the likely differences in large urban areas. We differentiated workers' compensation from other TRIEA-covered lines. While we have the data to undertake such analyses for large cities throughout the country, in this paper we provide the results only for one or two cities in three states: Texas (Houston and Dallas), California (Los Angeles and San Francisco) and New York (New York City).

The notion of policyholders' surplus

We start with our analysis of the impact of the deductible feature of TRIEA. Insurer *capital* represents the net worth of the company (assets minus liabilities). Capital enables the insurer to pay any losses above those that were expected. It serves as a safety net to support the risk an insurer takes on by writing insurance, and it helps ensure that the insurer will be able to honor its contracts. As such, insurers' capital supports the personal safety nets of homeowners, business owners, workers, dependents of heads of households and others who rely on insurance to provide financial compensation to rebuild their lives and businesses after covered losses occur.

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[20] The analyses undertaken in this paper are based on data provided by A.M. Best and Risk Management Solutions, discussions with key stakeholders concerned with terrorism insurance, and by responses to a questionnaire designed by the Wharton Risk Center and distributed to insurers by the American Insurance Association and the Property Casualty Insurers Association of America in 2005.

[21] The top insurers were those ranked by 2004 TRIA-line direct earned premium (DEP); that is the measure used to calculate insurers' 2005 deductible under TRIA. These insurers all had a total TRIA-line DEP equal to or above $10 million in 2004.

Insurer capital is traditionally referred to as "*policyholders' surplus*" (also called "surplus" for short). Despite the connotation of the term "surplus," there is nothing superfluous about it -- it is, in fact, an essential component supporting the insurance promise. The cost of that capital is an insurer expense that must be considered in pricing insurance, along with expected losses, sales and administrative expenses for policies written. Consider, for example, insurance for property damage caused by hurricanes. An insurer's expected losses are relatively low, because in a typical year the policyholder will not suffer a hurricane loss. However, losses could also be quite high -- far in excess of those expected at the time policies are priced -- as illustrated by the 2005 hurricane season. In the event of a serious hurricane, a substantial portion of the loss must be paid from insurer capital. For terrorism coverage, maximum losses are extremely high relative to expected losses, which makes the capital issue critical.

The evolution of the D/S ratio under the three-year TRIA terms: 2003-2005

Given the obligation of insurers to offer terrorism insurance to all their commercial policyholders under TRIA, the amount of loss that an insurer will eventually bear is based on its deductible. As described in the previous section of this paper, the insurer's deductible under TRIA (and TRIEA) is determined as a percentage of its total direct earned premiums (DEP) during the preceding year for TRIA lines. For each of the top 451 insurers A.M. Best provided us with the premiums written in TRIA commercial lines[22], to allow us to determine what the deductible (*D*) of each of these insurers had been under TRIA. Although we do not know the insurers' exact terrorism exposure[23], we will assume that they are providing this TRIA-based coverage to a large proportion of their policyholders in the urban areas we consider here. We can also distinguish P&C from workers' compensation market shares. Our interest is in determining how vulnerable insurers are to the possibility of suffering a large loss relative to their surplus. Those insurers with large deductibles (*D*) relative to their surplus (*S*) are the ones most at risk if they are providing terrorism coverage to most of their policyholders.

Figure 3 depicts the evolution of the *D/S* graphically for our sample of 451 insurers for these same three years (2003, 2004 and 2005). For each year, we plot the number of insurers whose *D/S* ratio lies between different percentage ranges in increments of 5 percent (e.g., [0% and 4.99%]; [5% and 9.99%], etc).

Of the total, 294 insurance companies providing terrorism insurance in the U.S. had a *D/S* ratio lower than 10 percent in 2003, compared with 139 insurers in 2005. If we consider higher *D/S* ratios, more than half of the firms had a *D/S* ratio greater than 15 percent in 2005 compared with less than one-sixth of the insurers in 2003. In 2003, only 36 insurers had a *D/S* ratio above 20 percent. There were 80 such insurers in 2004. In

[22] The original sample was made of all insurers with a TRIA-line total earned premium higher than $10 million in 2002, 2003 and 2004. Because the number of these insurers varied from one year to the next (establishment of new companies, mergers, bankruptcies, etc.), we selected a consistent sample of 451 insurers over the three years 2002-2004 that we used to determine the evolution of the *D/S* ratio under TRIA 2003-2005.

[23] This information would obviously be highly valuable but is not yet publicly available.

2005, 162 insurers (more than 35 percent of the sample) had a *D/S* ratio greater than 20 percent.

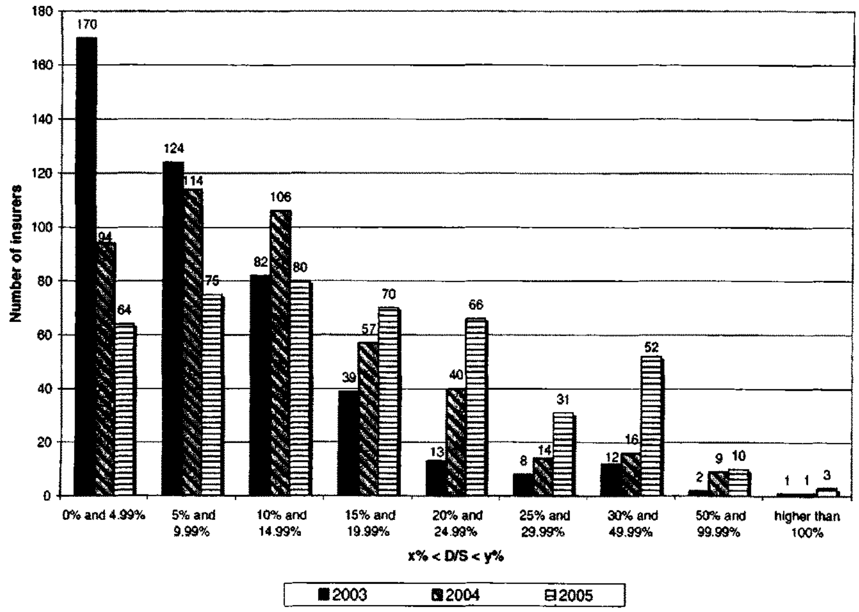

Figure.3. Change in *D/S* Ratio for the Top 451 Insurers under TRIA (2003-2005)

Focus on the Top 30 insurers – TRIA & TRIEA, 2003-2007

Insurers writing policies in an urban area know that there is some chance that the loss from a terrorist attack could reach or exceed their deductible (*D*). We focus our second series of analyses of the impact of TRIA on insurers for the 30 largest companies based on direct earned premiums in TRIA lines the preceding year. These companies wrote premiums that comprised 70 perce it of the total insurance market[24].

This analysis is based on the TI IA deductibles of 7 percent (2003), 10 percent (2004) and 15 percent (2005) of the dire t earned premiums (DEP) for TRIA line policies during the previous year. The data sh w clearly that there has been a major shift over the past 3 years as the TRIA deductible ercentage has increased. For example, as shown in Figure 4, only 5 insurers had a *D/S* ra o exceeding 10 percent in 2003 while more than half were in this category in 2005. Of he top 30 insurers, 8 of them have a *D/S* ratio exceeding 20 percent in 2005, while onl 1 was in this range in 2003.

It is interesting to see how the e ension of TRIA affects the *D/S* ratio of these 30 insurers for 2006 and 2007. We thus al analyze an increased deductible up to 17.5% of

[24] The top 30 insurers' TRIA line direct earned emiums in 2004 were about $147 billion lars out of the $210 billion provided by the top 451 insure f our sample in that same year.

TRIA-line direct earned premiums (DEP) in 2006, and to 20 percent in 2007. However, in order to determine "*D/S* (2006)" and "*D/S* (2007)" for each of the 30 companies under this scenario, we need to know what would be their TRIA-line DEP and their surplus in 2005 and 2006, respectively. As these data are not available yet we do extrapolate from the past. We base our analysis on the annual percentage change in these two numbers over the three-year period (2002-2004) for each of the thirty companies[25]. We then extrapolate these figures for the next two years to estimate direct earned premiums (DEP) for TRIA lines and surplus (*S*) for 2005 and 2006.

Figure 4 depicts the number of insurers (y-axis) whose *D/S* exceeds pre-specified values of *x* percent (x-axis); years 2003, 2004 and 2005 are exact figures, 2006 and 2007 result from our prospective analysis. Should this estimation be right, 18 of the top 30 insurers would have a TRIEA deductible higher than 10 percent of their surplus in 2007; for 13 of them that would be higher than 20 percent (vs. 8 in 2005 and 1 in 2003), including for 6 of the 10 largest insurers (Appendix provides the complete set of results). Moreover, none of theses 30 insurers had a D/S ratio higher than 50% in 2005. there will be 3 such insurers in 2006 (50%, 56% and 66%, respectively) and 2007 (the D/S ration increased dramatically up to 57%, 70% and 100%).

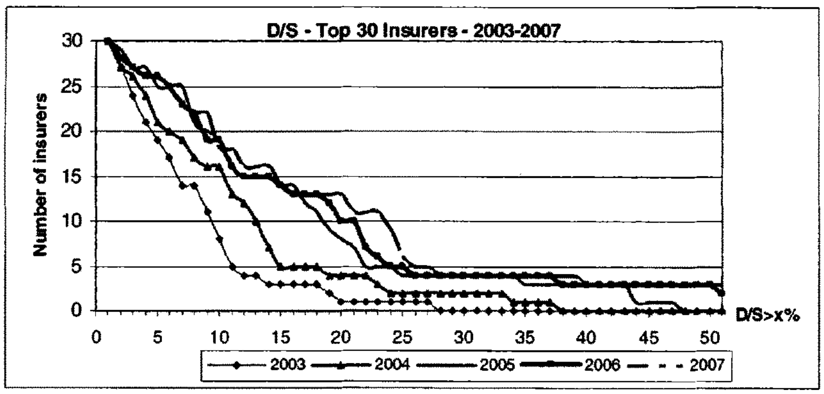

Figure 4. Number of the Top 30 Insurers whose *D/S* Exceeds Pre-specified Values of *x* Percent

4. Constructing Terrorist Attack and Loss-Sharing Scenarios

Due to the difficulty in estimating the likelihood of a terrorist attack, insurers utilize scenarios to determine their maximum exposure to a range of possible attacks that

[25] This can be done for the largest companies as changes are "relatively" stable over these three years and consistent with the market. However, extrapolating that for the other 431 smaller insurers does not work well because for most of them there is a huge difference between (2004/2003) and (2003/2002): taking the mean of it is not likely to reflect what the evolution has really been from 2004 to 2005.

vary by location and mode of attack[26]. However, few insurers consider the likelihood of these scenarios occurring in determining their exposure[27].

Given insurers' interest in determining their exposure using deterministic scenarios, and to more fully understand the nature of the economic and human losses from a terrorist attack on business property, we constructed a set of scenarios to analyze the impact of financial losses between the non-insured victims, the insurers and the taxpayers under TRIA and TRIEA. We also utilized these scenarios to analyze the effect on the distribution of losses should TRIA have not been renewed so that the private market (e.g., insurers, property owners and/or employers) would be responsible for all the losses.

As discussed earlier, there are no easy answers to these loss allocation questions -- they will be determined by the nature and location of the terrorist attacks and the number of insurers providing coverage. For example, if the attack is a relatively small one on a single building, and if large insurers with high deductibles cover the target building, then there will be little, if any, federal government involvement in loss payments. However, if a few smaller companies with low TRIA deductibles cover the target building, then the federal government will pay a significant portion of their losses, and then will partially or fully recoup these payments later from all policyholders purchasing commercial insurance.

Evidence indicates that most insurers focus on damage from two-to-ten-ton truck bombs in determining the losses they could suffer from a terrorist attack[28]. As an element of comparison, the attack in the front of the Alfred P. Murrah Federal Building in Oklahoma City in 1995 was perpetrated with a two-and-a-half-ton truck bomb. One reason for this focus is that A.M. Best uses this type of scenario in analyzing the impact of a terrorist attack on insurers' balance sheets. Although other scenarios could be used to evaluate losses from a terrorist attack[29], we analyze the effect on property damage and workers' compensation losses of a five-ton truck bomb exploding in each of the United States' 447 largest commercial high-rise buildings.[30].

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[26] When asked the question "Does your company consider scenarios in its catastrophe/exposure management process?" 92 percent of the insurers who responded to the Wharton questionnaire answered "Yes". One company responded to the above question by noting: *"Our company uses deterministic terrorist attack scenarios, and the associated Probable Maximum Loss (PML) estimates of these scenarios, to establish and manage exposure concentrations within major metropolitan areas and/or surrounding landmark properties."*; see Wharton Risk Center (2005).

[27] As illustrated by the following responses to the question: "Do you take estimates of the likelihood of the various known scenarios into account when making underwriting decisions?":

> *"Not really. There is little historical data to predict future events."*
>
> *"Likelihood is very unpredictable for terrorist acts."*
>
> *"Our company does not believe that estimates of the frequency of terrorist attacks are credible at a country, regional or specific property level."*; see Wharton Risk Center (2005).

[28] For example, 90% of the Wharton questionnaire discussed above indicated that they were using that type of scenario in evaluating their exposure: 7 of the 10 insurers responding to the questionnaire indicated that they used 5-ton bomb scenario and 2 insurers indicated they used a two-ton truck bomb scenario. See Wharton Risk Center (2005). *Ibib.*

[29] For example, the RAND Corporation has undertaken a detailed study on the impact of aircraft attacks on high rises in the United States.

[30] We are grateful to Andrew Coburn from Risk Management Solutions who provided us w[illegible]se data.

Scenario Methodology

Figure 5 describes the methodology for allocating losses from a specific scenario to the potential victims as well as to the insurers and the federal government immediately after a terrorist attack.

The loss allocation process can be divided into several steps:

- *Step 1:* Identify the nature of the terrorist attack: What's the target (represented by the target picture in figure below)? What mode of attack? Is the attack considered a "certified" or "non-certified" event? What are the direct losses potentially by insurance?
- *Step 2:* Determine losses covered by insurance. What was the insurance take-up rate at the target location? What portion of the losses is actually covered by insurance (by line)?
- *Step 3:* Determine what proportion of losses is assumed by each of the affected parties. Who's paying what? What insurers are responsible for what part of the insured losses? How the loss-sharing process under TRIA and TRIEA does operate? (the table at the top of the figure below)

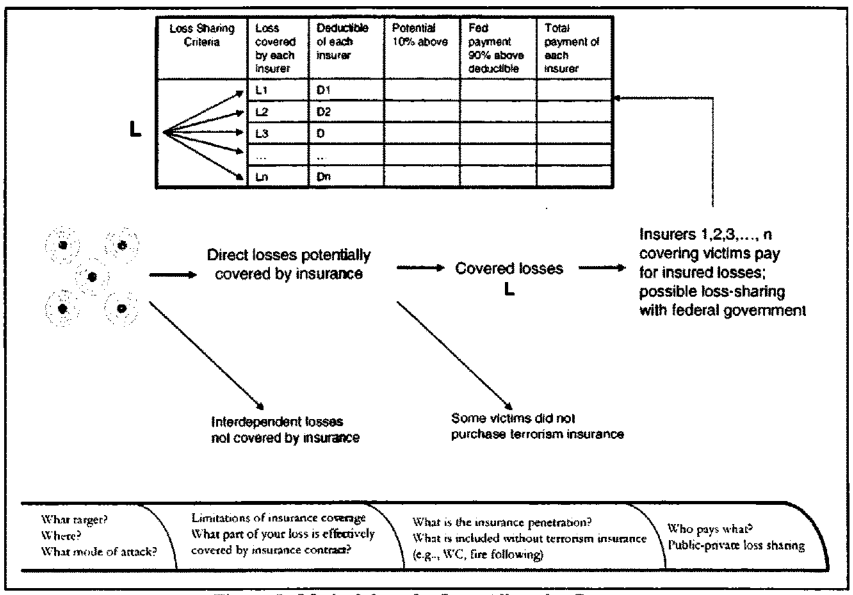

Figure 5. Methodology for Loss-Allocation Process

Figure 6 provides the distribution of loss for each of 447 commercial high-rise buildings on two major insurance lines covered by TRIA (and TRIEA): property (including business interruption) and workers' compensation. The explosion of a five-ton truck bomb would inflict not only disastrous damage to the specific building that terrorists want to target, but also to other adjacent structures. The impact would mainly

depend on the type of building and the number of employees who work there[31]. For example, the distribution of losses described in Figure 6 indicates that a five-ton truck bomb on Building A would inflict $4.7 billion in workers' compensation losses and $3.9 billion in property losses[32]. An attack on Building B, in a different city, would inflict $6.8 billion in workers' compensation losses and $8.7 billion in property losses. The maximum combination of property and workers' compensation losses is estimated to be between $15 and 16 billion for a single event (Buildings B and C).

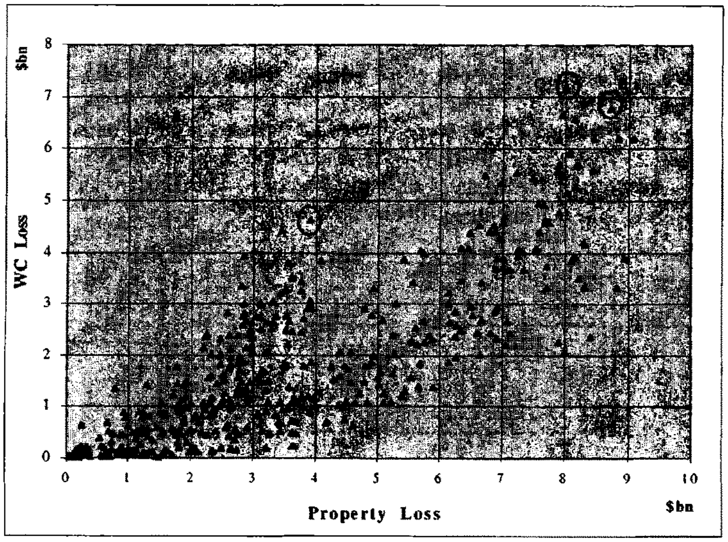

Figure 6. Projected Property Losses and Workers' Compensation Losses from Five-Ton Bomb Attacks to 447 High-Rise Buildings in the United States (in $ billion)
[Each triangle represents one specific high-rise building used in the simulation; Triangles A, B, and C are three specific buildings we discussed in the core of the text]

Similar simulations can be run using a scenario of an aircraft crashing against each of the 447 high-rise buildings (Figure 7). Such a simulation reveals that the magnitude of loss for property and workers' compensation for each of the 447 simulations would be lower. Workers' compensation maximum losses are likely to be capped at $3 billion[33] and property at $8 billion for different buildings. As with the truck bomb scenario, if simultaneous attacks were to occur in different locations, the losses would be additive.

[31] For the simulation, we assume that the attack would occur at 10 a.m. on a Wednesday -- a time when most employees would be in the building.
[32] For obvious reasons we do not reveal here the nature of any of these targets.
[33] The insured WC losses due the 9/11 attacks were $1.3 billion.

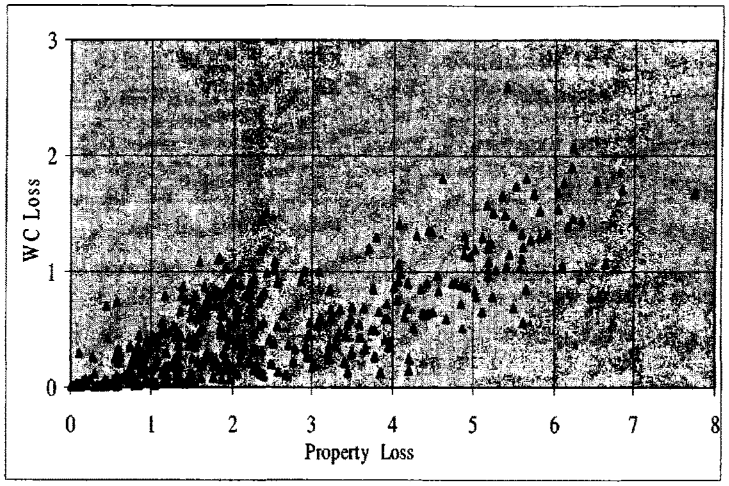

Figure 7. Projected Property Losses and Workers' Compensation (WC) Losses from Aircraft Attacks to 447 High-Rise Buildings in the United States (in $ billion)
[Each triangle represents one specific high-rise building used in the simulation]

5. Effect of Location and Attack Size on Loss Sharing under TRIA

How would losses from foreign terrorist attacks on U.S. soil be distributed across the relevant affected parties? This question can be answered differently, depending on different risk-sharing scenarios that vary with respect to location, magnitude of damage and terrorism risk insurance take-up rate.

Assumptions

We make a number of assumptions to examine these losses. Because data are not available on individual insurer's terrorism exposure, we utilize *market shares* of insurers to allocate losses from a terrorist attack between the 451 largest insurers that comprise 97 percent of the market with respect to 2004 TRIA-line direct earned premiums (DEP)[34]. Market shares appear to be the most reasonable proxy for analyzing loss sharing across the affected parties. In addition, we separate property insurance lines from workers' compensation lines. In the case of property coverage we utilize premiums written for nationwide commercial coverage. With respect to workers' compensation (WC) coverage we have access to insurers' market shares in the relevant states and therefore allocate losses using these data[35].

[34] Since data are not available on individual insurers' terrorism exposure, market share appears to be the most reasonable proxy for analyzing loss sharing across the affected parties.

[35] For each of the three states on which we focus our analysis, there are major competitive workers' compensation insurers: New York State Insurance Fund, State Compensation Insurance Fund of California and Texas Mutual Insurance Company. The State Compensation Insurance Fund of California covers half

We first undertake a comparative analysis of loss distribution between the affected parties as we vary location, level of loss and take-up rate under a scenario in which the terrorist attacks take place in 2005 with TRIA in place. In this scenario, insurers will pay their entire loss up to their TRIA deductible (D: 15 percent of the TRIA-line DEP in 2004) and then an additional 10 percent above D, with the federal government paying the other 90 percent[36]. Under TRIA the federal government would levy a surcharge against all policyholders purchasing commercial insurance to recoup part of its payment within the total insurers' payments and the insurance industry retention ($15 billion in 2005) ("mandatory recoupment").

Effect of Attack Location

The effect on loss sharing of two 5-ton truck bomb attacks varies greatly depending on the location of the attack (Table 1). Under our simulation, we compare the total property loss ($15 billion) and workers' compensation loss ($10 billion) in three major cities (New York City for New York, Los Angeles for California, and Houston for Texas). We also assume that half of the property damage to commercial enterprises in the buildings is covered by either terrorism insurance or fire-following insurance, and that all the workers' compensation losses are covered by insurance. This scenario results in a $17.5 billion in insured loss out of the $25 billion total. A sensitivity analysis relative to the insurance take-up rate is undertaken later in this subsection.

Table 1. City Comparison of Simulated Scenario Involving five-ton Truck Bombs ($25 billion in losses: 50 percent coverage for property; 100 percent coverage for workers' compensation [WC]); 2005 TRIA

City Comparison	Not-insured [37]	Total insured	Loss Sharing Insurers' Payments	All Policyholders[38]	Final Government Taxpayers
New York, NY	$7.5bn	$17.5bn	$13.27bn	$1.73bn	$2.5bn
		Insured loss sharing	*76%*	*10%*	*14%*
Los Angeles, CA	$7.5bn	$17.5bn	$13.1bn	$1.9bn	$2.5bn
		Insured loss sharing	*75%*	*11%*	*14%*
Houston, TX	$7.5bn	$17.5bn	$14.5bn	$0.5bn	$2.5bn
		Insured loss sharing	*83%*	*3%*	*14%*

of workers' compensation lines in the state while the major insurers in New York and Texas cover 40 percent and 20 percent respectively of the total WC coverage in their states.

[36] We assume that insurers have not purchased reinsurance. If they have, then the amount of their loss would be somewhat reduced. We assume a zero deductible for the policyholder on their terrorism insurance policy. This assumption simplifies the analysis but does not affect the qualitative results.

[37] Retained by policyholders who suffered the losses but were not covered against terrorism.

[38] The federal government recoups the 90% portion of the insured loss it initially paid above insurers' payments up to an industry aggregate of $15 billion in 2005 (see Section 2 on TRIA design).

Under this scenario, the insurers and policyholders will absorb $15 billion of the $17.5 billion insured loss in each of the three cities. However, the distribution of payments between insurers and all policyholders differs across metropolitan areas (due to different workers compensation market shares). In both New York and California, two or three large insurers provide a very large portion of workers' compensation coverage for the entire state -- they will have a much higher loss relative to their TRIA deductible than workers' compensation insurers in Texas, where there is less concentration of coverage in one company. Hence, the federal government will initially pay more in New York and California (the 90 percent portion above the deductible of the few key workers' compensation insurers), and then recoup part of that payment against all policyholders. In all three cities, the federal government covers $2.5 billion of the loss, which is shared by all U.S. taxpayers[39].

Effect of Size of Loss

Changing the size of the loss from $0.5 billion to $100 billion affects the distribution of payments (Table 2). We detail the effect in one specific metropolitan area (New York, NY), using the same assumptions as in the previous section: half of the property damage to commercial enterprises in the buildings are covered by either terrorism insurance or by fire-following insurance, and all the workers' compensation losses are covered by insurance.

Table 2. Impact of Varying Losses from 5-ton Truck Bomb Attacks on New York City (50 percent insurance coverage for property; 100 percent coverage for workers' compensation [WC]); 2005 TRIA

Loss Scenarios	Not-insured[40]	Total insured	Insurers' Payments	All Policyholders[41]	Final Goverment Taxpayers
Total: $0.5bn Property: $0.25bn WC: $0.25bn	**$125mi**	**$375mi**	**$375mi**	**$0**	**$0**
		Insured loss sharing	*100%*	*0%*	*0%*
Total: $5bn Property: $2.5bn WC: $2.5bn	**$1.25bn**	**$3.75bn**	**$2.97bn**	**$780mi**	**0$**
		Insured loss sharing	*79.2%*	*20.8%*	*0%*
Total: $15bn Property: $9bn WC: $6bn	**$4.5bn**	**$10.5bn**	**$8.23bn**	**$2.27bn**	**$0**
		Insured loss sharing	*78.3%*	*21.7%*	*0%*

[39] The U.S. Department of Treasury has the authority to collect the $2.5 billion through surcharges if it elects to do so, but here we only allow a recoupment for losses between the insurer's payments and the $15 billion market retention in 2005.
[40] Retained by policyholders who suffered the losses but were not covered against terrorism.
[41] The federal government is assumed to recoup the portion of insured loss it initially paid above insurers' payments up to an industry aggregate of $15 billion in 2005.

Total: $25bn Property: $15bn WC: $10bn	**$7.5bn**	**$17.5bn**	**$13.27bn**	**$1.73bn**	**$2.5bn**
		Insured loss sharing	*75.9%*	*9.9%*	*14.2%*
Total: $40bn Property: $28bn WC: $12bn	**$14bn**	**$26bn**	**$20.6bn**	**$0**	**$5.4bn**
		Insured loss sharing	*79.2%*	*0%*	*20.8%*
Total: $40bn Property: $12bn WC: $28bn	**$6bn**	**$34bn**	**$18.7bn**	**$0**	**$15.3bn**
		Insured loss sharing	*55%*	*0%*	*45%*
Total: $100bn Property: $50bn WC: $50bn	**$25bn**	**$75bn**	**$34.1bn**	**$0**	**$40.9bn**[42]
		Insured loss sharing	*45.5%*	*0%*	*54.5%*

The figures reveal that, if losses from terrorist attacks do not exceed $15 billion, the insurance companies and policyholders will bear all of the losses. We considered two cases for which the total loss is $40 billion. In Case 1, property loss is $28 billion and workers' compensation is $12 billion. In Case 2, the dollar figures are reversed: property loss is $12 billion and workers' compensation is $28 billion. Even if the total loss is the same, the loss sharing differs considerably between these two cases. While taxpayers would end up paying $5.4 billion in Case 1, they would pay $15.3 billion in Case 2. The difference is due to both the level of insured loss and the distribution of loss among insurers who have different deductibles under TRIA. In other words, a $1 billion loss due to property damage is shared differently than a $1 billion loss of workers' compensation, because the insurers are different. If the terrorist attacks lead to losses of $100 billion, under a scenario in which losses are half property, half workers' compensation, then the U.S. taxpayers will bear 54.5 percent of the total insured losses.

6. Increased Burden on Insurers and Commercial Enterprises (covered or not against terrorism) in 2006 and 2007

How are these results likely to be modified this year and in 2007? There is no definitive answer to that question now. The design of the program requires one to specify direct earned premium under TRIEA lines collected the previous year (i.e., 2005), and these data will not be available before mid-2006.

Some have use the "total industry DEP/deductible" as a proxy to measure how terrorism losses would be shared between insurers, all policyholders and taxpayers. However, our data analyses have shown that the loss shares differed very significantly depending on whether one considered such an–incorrect–aggregate approach or the more

[42] Including $18.3 billion that would represent the 90% federal payment above the New York Insurance Fund's TRIA deductible.

granular insurer-based one on which TRIEA is really based[43]. What can be done at this time is to understand under in what directions loss sharing is likely to evolve under the revised design of the terrorism insurance program.

Effect of the Increased Industry Market Retention on Loss Sharing

While most of the debate has been focused on the increase in insurer deductible, the major change in TRIEA is the increase of insurance industry retention from $15 to $25 billion in 2006. In Table 3, we utilize the results of the analyses summarized in Table 2 but modify the retention level to reflect this change (results are indicated in [ ]).

For total insured losses under $15 billion there is, of course, no difference. For the $25 billion loss scenario, however, the $2.5 billion that would have been paid by taxpayers in 2005 is now paid by policyholders. The difference is even more significant for the two $40 billion scenarios: commercial policyholders, whether they are covered against terrorism or not, pay $4.4 billion and $6.3 billion respectively. For the same $100 billion scenario than the one used before, there is no difference because insurers already pay $34.1 billion in claims, which is above the $25 billion retention -- in that case there is no mandatory recoupment by the federal government.

Table 3. Impact of Varying Losses from 5-ton Truck Bomb Attacks on New York City 50% Insurance for Property Coverage; 100% Insurance for workers' compensation; 2005 ; $15 billion industry market retention [$25 billion industry market retention]

		[illegible]			
Loss Scenarios	**Not-insured[44]**	**Total insured**	**Insurers' Payments**	**All Policyholders[45]**	**Final Goverment Taxpayers**
Total: $0.5bn Property: $0.25bn WC: $0.25bn	**$125mi**	**$375mi**	**$375mi** **[$375mi]**	**$0** **[$0]**	**$0** **[$0]**
		Insured loss sharing	*100%*	*0%*	*0%*
Total: $5bn Property: $2.5bn WC: $2.5bn	**$1.25bn**	**$3.75bn**	**$2.97bn** **[$2.97bn]**	**$780mi** **[$780mi]**	**$0** **[$0]**
		Insured loss sharing	*79.2%*	*20.8%*	*0%*
Total: $15bn Property: $9bn WC: $6bn	**$4.5bn**	**$10.5bn**	**$8.23bn** **[$8.23bn]**	**$2.27bn** **[$2.27bn]**	**$0** **[$0]**
		Insured loss sharing	*78.3%*	*21.7%*	*0%*
Total: $25bn Property: $15bn WC: $10bn	**$7.5bn**	**$17.5bn**	**$13.27bn** **[$13.27bn]**	**$1.73bn** **[$4.23bn]**	**$2.5bn** **[$0]**
		Insured loss sharing	*75.9%*	*9.9%*	*14.2%*
			75.9%	*[24.1%]*	*[0%]*

[43] While still imperfect because we consider each insurer's market share in the location where we simulate the attack, not the real coverage provided by that insurer for the specific target.

[44] Retained by policyholders who suffered the losses but were not covered against terrorism.

[45] The federal government is assumed to recoup the portion of insured loss it initially paid above insurers' payments up to an industry aggregate of $15 billion in 2005.

Total: $40bn Property: $28bn WC: $12bn	**$14bn**	**$26bn**	**$20.6bn** **[$20.6bn]**	**$0** **[$4.4bn]**	**$5.4bn** **[$1.0bn]**
		Insured loss sharing	*79.2%*	*0%*	*20.8%*
			[79.2%]	*[16.9%]*	*[3.9%]*
Total: $40bn Property: $12bn WC: $28bn	**$6bn**	**$34bn**	**$18.7bn** **[$18.7bn]**	**$0** **[$6.3bn]**	**$15.3bn** **[$9bn]**
		Insured loss sharing	*55%*	*0%*	*45%*
			[55%]	*[18.5%]*	*[26.5%]*
Total: $100bn Property: $50bn WC: $50bn	**$25bn**	**$75bn**	**$34.1bn** **[$34.1bn]**	**$0** **[$0]**	**$40.9bn**[46] **[$40.9bn]**
		Insured loss sharing	*[45.5%]*	*0%*	*[54.5%]*

Effect of the Increased Deductible and Market Conditions

As discussed earlier, TRIEA increases the insurer deductible, as a percentage of the TRIA-line DEP in the previous year, from 15 percent in 2005 to 17.5 percent in 2006, and to 20 percent in 2007. While this represents a difference in 2.5 point of percentage each year, this translates into a 17 percent increase in 2006 and another 14 percent increase in 2007 (in absolute value). Between 2005 and 2007, for a given DEP level, there will be a 33 percent increase in the insurer's deductible under TRIEA.

The increased insurer deductible is affected by market conditions as well, if one expects TRIAE-line premiums to evolve over time. For example, the total TRIA-line premiums for our 451-insurers sample evolved as follows: $170.9 billion in 2002, $197.2 billion in 2003 (a 17 percent increase from the previous year), and $210.6 billion in 2004 (a 7 percent increase from 2003). After the 2004 and 2005 hurricane seasons, it would not be surprising the see the market hardening so that a 10 to 15 percent annual increase in TRIEA-line premiums for 2005 and 2006 appears to be a reasonable assumption.

Suppose now that the portfolio of a representative insurer X follows the same evolution of the aggregate sample. If annual TRIA-line DEP in 2004 of insurer X were $100 million then its terrorism coverage deductible under TRIA for 2005 would have been $15 million. Assuming a 13 percent increase in TRIE-line DEP in 2005, then insurer X's deductible under TRIEA for 2006 would be $19.775 million (i.e. .175 ($113 million)). This represents a 31.8 percent increase in its terrorism deductible from the previous year in absolute value. If premium increases follow a similar pattern between 2005 and 2006, then insurer X's deductible under TRIEA for 2007 would be $25.54 million (i.e. .20 ($127.69 million)).

This reflects a 70 percent increase over its deductible in 2005. The impact on the precise amount of terrorism loss sharing can be determined after data from 2005 becomes available. What is clear is that insurers and policyholders will pay a much greater loss

[46] Including $18.3 billion that would represent the 90% federal payment above the New York Insurance Fund's TRIA deductible.

share in 2006 and 2007 than under the 2005-attack scenario due to the higher deductible and higher market retention and hence the general taxpayer will incur a smaller portion of the loss.

7. Private Efficiency, Public Vulnerability: Will Insurers Strategize if the Current Program is Made Permanent?

We can use the scenario methodology to analyze the question as to how insurers will react if the program is made permanent in its current form. Will insurers' exposure to terrorism losses change from what it currently is under TRIEA and, if so, what would be the impact on loss sharing between the affected parties following a large-scale terrorist attack on U.S. soil?

To examine this question, we assume that TRIEA officially becomes a permanent program with the insurer's deductible at 17.5 percent of their TRIEA-line DEP from the previous year. All insurers know that they will have to pay for all losses they incur below this deductible (*D*) and 10 percent of the loss above it, the remaining 90% eventually paid by other parties (taxpayers, policyholders)[47]. An insurer with a very low deductible/surplus ratio would have a rationale for this insurer to take advantage of the small percentage it will have to absorb if its loss exceeds the TRIA deductible. Any insurer with a low deductible/surplus (*D/S*) ratio would have an economic incentive to write a large number of policies in a concentrated area subject to a terrorist attack (e.g. Times Square, Wall Street area) due to the positive correlation in these losses. In other words, the insurer knows that if one of these buildings is damaged or destroyed, the surrounding ones are also likely to suffer severe damage.

Determining Terrorism Coverage Using an "E Gaming Strategy"*

To examine how the aggregate exposure/surplus ratio affects the amount of coverage an insurer will want to provide if TRIEA is extended indefinitely, we use the following notation:

E* = maximum insured terrorism exposure (i.e. worst case scenario)

E = actual dollar claims incurred by an insurer from a worst case scenario

DEP = direct earned premiums written for TRIA lines of coverage

D = aDEP = TRIA/TRIEA deductible determined by the percentage a (e.g. a = 17.5% in 2006)

S = current surplus

X = E/S = aggregate exposure for terrorism/surplus ratio

Y = D/S = deductible/surplus ratio

[47] In this subsection we use the 2006 design of the loss sharing; similar results of the "gaming strategy" can be determined under the 2007 loss sharing design.

Given the difficulties in estimating the probability of a terrorist attack, rating agencies focus on deterministic scenarios in evaluating an insurer's credit rating. We focus our estimates on insured losses from a five-to-six truck bomb scenario in determining the maximum exposure an insurer will be willing to accept. If an insurer experiences insured losses of E^*, it determines its dollar claims (E) with one of two equations:

$$E = E^* \quad \text{if } E^* \leq D \tag{1}$$

$$E = D + .1\,(E^* - D) \quad \text{if } E^* > D \tag{2}$$

A possible line of analysis would be to suppose that the maximum amount of terrorism exposure (E^*) that an insurer wants to write is determined by a desired aggregate exposure/surplus (E/S) ratio given by x (e.g. $x = 10\%$). To determine the value of E^* the insurer first computes $D/S = y$ and compares the value of y with x.

- *If* $y \geq x$, the insurer knows that its claims are determined by the first equation (1) (i.e. $E = E^*$), because it is responsible for the entire loss on its own given that $D/S > x$. The insurer thus sets $E^* = xS$.

- On the other hand, if $y < x$, the insurer knows that its claims are determined by the second equation (2), and the government will cover 90 percent of the insured loss above its TRIA deductible, given the federal backstop provision of TRIA. In this case, the insurer computes $E/S = D/S + .1\,(E^*/S - D/S)$ which can be written as $x = y + .1(E^*/S - y)$ or $E^* = (10x - 9y)S$ (3)

To illustrate this strategy with a simple numerical example, we assign the values of $D = 10$, $S = 200$, $y = .05$ and $x = .10$ Since $y < x$, E^* is determined by (3) as follows:

$$E^* = (1\text{-}0.45)200 = 110$$

If an insurer were responsible for the entire loss, then $E = E^*$ for all values of E^* so that $E^* = xS$. For this example, $E^* = .10(200) = 20$, which is considerably lower than the scenario in which the insurer is responsible for only 10 percent of the loss, as it was under TRIA and still is under TRIEA in 2006.

To examine the impact of a permanent TRIA-like program on the amount of terrorism coverage written by insurers, we assume that each insurer is concerned with maintaining an aggregate exposure from deterministic scenarios at 10 percent of its surplus (S)[48]. E, then, is be the *ultimate exposure* of the insurer; that is, what it will pay after sharing part of the loss with other parties.

E^* represents the *aggregate exposure* that an insurer is willing to risk if it is responsible for ten percent of the loss above D =15 percent (e.g., the arrangement under TRIA in 2005) and it wants to set a value of $E/S = D + .1(E^* - D) = 10\%$.

We define an E^* *gaming strategy* as the decision by an insurer to increase significantly the amount of coverage it provides in order to take advantage of the 90%

[48] This assumption represents a v rudent behavior. Indeed, 17 of the top 30 insurers already have a D/S ratio equal or higher than 10 per 2005.

risk-sharing arrangement with the government, and at the same time to collect a significant amount of terrorism insurance premiums[49].

We focus on the locations where a large terrorism loss is more likely. To make the data analysis manageable, we have limited our sample of insurers to those who already provide the largest terrorism coverage in urban areas. We focused on the top 30 insurers based on TRIA-line direct earned premiums in 2004 and then eliminated the 7 companies who are small business and personal lines writers. This group of 23 large insurers actually accounts for about two-thirds of the TRIA-lines direct earned premiums. For the sake of simplicity, we then make the assumption that these 23 insurers cover 100 percent of the insured losses in the city we consider. We then analyze how losses would be shared under TRIA and compare this with a design of a "permanent TRIA."

For each insurer, we can determine its aggregate terrorism coverage in urban areas. For insurers with a *D/S* ratio greater than 10 percent, insurers limit their exposure to 10 percent of their surplus ($E^* = E$). Those with *D/S* less than 10 percent could offer much more coverage than under TRIA, particularly those with very small *D/S* due to a large surplus ($E^* > E$). Figure 8 depicts the difference that fixing a threshold of *E/S* = 10 percent would have on insurers' decisions regarding how much terrorism coverage to offer, depending on whether the insurer had a *D/S* ration higher than 10 percent (Insurer (a); left part of the graph) and those with *D/S* less than 10 percent (Insurer (b); right part of the graph). In both cases, there are two bars. The solid gray one on the left indicates the *D/S* ratio of the insurer in 2005, the one made up of oblique lines on the right indicates exposure based on the constraint that *E/S* = 10 percent.

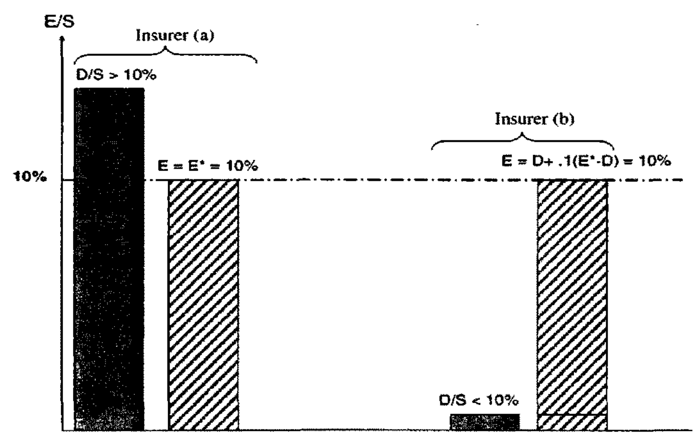

Figure 8. Insurer's Exposure Limited to 10% of Its Surplus

The aggregate exposure for each of these two types of insurer is depicted in Figure 9. An insurer with considerable business in non-TRIA lines such that its surplus is high but its deductible is quite low will take advantage of the structure of TRIA's

program (if it is made permanent) by increasing its aggregate exposure considerably from the current level, up to E^*. For example, insurer (b) on Figure 9 will only pay 10 percent of any loss above its deductible (D; the portion represented by oblique lines) with the other 90 percent paid by taxpayers and possibly all policyholders under the federal government's recoupment arrangement under TRIA (the area represented by horizontal lines).

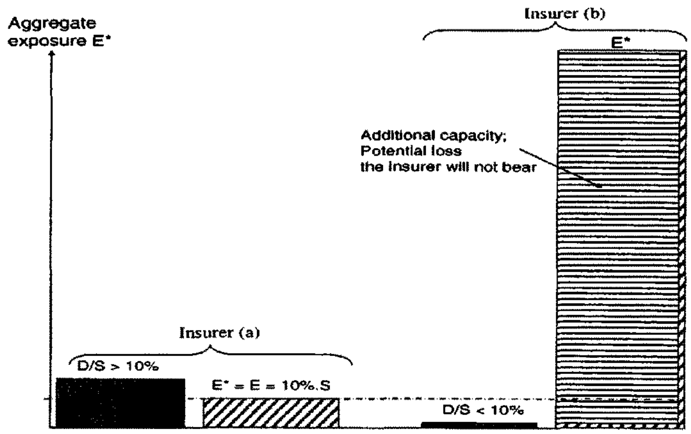

Figure 9. Aggregate Exposure of Insured Losses; Additional Capacity Provided by Insurers with D/S<10%

An important difference from the analyses undertaken in the previous section of the paper is that market share is now based on each insurer's E^*. In this case, we assume that E^* is composed of both property and workers' compensation coverage. As a result the market shares of insurers providing terrorism coverage would be quite different if a TRIA-like program were made permanent. In particular, the New York State Insurance Fund would likely not be the major provider of workers' compensation coverage anymore, as its surplus is much lower than other large insurers; the company is therefore constrained in how much terrorism insurance it will be willing to write.

Using E^*, one can then determine how the coverage from a terrorist attack would be spread across insurers. Because insurers with low *D/S* ratios are willing to write considerably more property coverage at relatively low prices in metropolitan areas if TRIA is made permanent, all commercial enterprises will expect to be insured against property losses (we assume a 100 percent take-up rate)[50].

[50] It is unclear how terrorism insurance will be priced under this scenario. Insurers with low *D/S* ratios competing for business in urban areas will have an economic incentive to reduce their price as they expand their coverage, because they know they will be only responsible for 10 percent of any loss greater then *D* -- something an insurer with more limited surplus cannot do. As a result, the major providers of coverage will be winnowed down to only a few insurers.

Allocation of Losses Across Affected Stakeholders

As mentioned earlier, data for 2006 are not available yet, so we provide the analysis by making the design of TRIA-2005 permanent. We discuss in this section who pays for the losses under TRIA in 2005, and should TRIA be made permanent, for two scenarios in New York City: a $25 billion and $100 billion terrorist attack using five-ton truck bombs. Under TRIA in 2005, the allocation of losses is based on each insurer's market share of total property-casualty premiums for commercial coverage, and insurers are assumed **not** to be using an E^* *strategy*. The now 100 percent take-up rate when TRIA is made permanent results in a shift of non-insured losses ($7.5 billion and $25 billion, respectively) to either all the policyholders or the government/taxpayers (Table 4). On first glance it seems counterintuitive that insurers will pay less for terrorism losses when their take-up rate is 100 percent rather than 50 percent. The reason is that insurers with low D/S ratios will increase their exposure very significantly, as shown in Figure 9. Following a terrorist attack, these few insurers will be initially responsible for the largest part of the losses.

Under TRIA in 2005, these losses would have been spread over a much larger number of insurers, who collectively would have absorbed more of the loss because it would fall below their values of D. In other words, under a permanent TRIA program these few insurers will end up paying a very limited portion of their exposure (they actually pay E not E^*), while the federal government will cover 90 percent of the loss above their D levels. As with the other analyses, we assume that the federal government will pay for any losses above the $15 billion industry market retention without recoupment of any of their expenditures under the TRIA federal backstop provision.

Consider the insurance scenario with a $25 billion loss. Because the total loss will increase from $17.5 billion (with a 50 percent take-up rate) to $25 billion (with a 100 percent take-up rate), the general taxpayer's share of the loss will increase from $2.5 billion to $10 billion – that is a 300 percent increase from the current TRIA program. The difference between the $15 billion insurance industry retention and insurers' payments of $13.3 billion will be charged against all policyholders who will experience a 288 percent increase in payments. The difference in market shares induced by a few insurers playing an E^* strategy would result in a 37 percent decrease in insurance industry payments, even if all losses caused by the attacks are now covered (Table 4).

In the more extreme case of a $100 billion loss, when some insurers decide to significantly increase their aggregate exposure after learning that TRIA is renewed indefinitely, the insurance industry would pay considerably less in claims even though the take-up rate on property coverage is assumed to be 100 percent. More specifically, due to their higher exposures when TRIA is extended indefinitely, the insurers will receive a larger subsidy from the federal government than they would under TRIA today. Furthermore the insurance industry loss with either a 50 percent or 100 percent take-up rate is greater than the $15 billion market retention rate. We assume that taxpayers cover the loss above this amount so there will be no recoupment of the subsidy by the federal government and the commercial policyholders will not be taxed at all. Hence the insurers actually pay less when total insured losses are $100 billion than when they are $75 billion

(Table 4). Indeed, the larger total insured loss due to the increased coverage amount is passed on to the U.S. taxpayers who now absorb $79.3 billion in loss payments compared with $51 billion under TRIA in 2005.

Table 4. Distribution of Losses under TRIA-2005 and if TRIA is Made Permanent
($25 billion Loss in New York City)

			Insured Loss Sharing		
	Non-insured	**Total insured**	**Insurers' Payments**	**All Policyholders[51]**	**Final Fed. Gov Taxpayers**
SCENARIOS					
TRIA-2005 – 50% take-up rate on Property Insurance – 23 insurers					
Total: $25bn Property: $15bn WC: $10bn	**$7.5bn**	***$17.5bn***	***$13.3bn***	***$1.7bn***	***$2.5bn***
		Insured loss sharing	*76%*	*9.8%*	*14.2%*
TRIA Extended Indefinitely – 100% take-up rate – 23 insurers					
Total: $25bn Property: $15bn WC: $10bn	**$0**	**$25bn**	**$8.4bn**	**$6.6bn**	**$10bn**
		Insured loss sharing	*46%*	*14%*	*40%*
		Change in final payments	-37%	+288%	+300%
TRIA-2005 – 50% take-up rate (TRIA-line premium market) – 23 insurers					
Total: $100bn Property: $50bn WC: $50bn	**$25bn**	**$75bn**	**$24bn**	**$0**	**51bn**
		Insured loss sharing	*32%*	*0%*	*68%*
TRIA Extended Indefinitely – 100% take-up rate– 23 insurers					
Total: $100bn Property: $50bn WC: $50bn	**$0**	**$100bn**	**$20.7bn**	**$0**	**$79.3bn**
		Insured loss sharing	*20.7%*	*0%*	*79.3%*
		Change in final payments	-14%	0%	+55%

If one wants to design a program that encourages insurers to write coverage, then a permanent terrorism insurance program like TRIA or TRIEA will be successful due to the very large subsidy the government provides to any insurer whose losses exceed *D*. The very large insurers with low *D/S* ratios will provide most of the coverage and pay very little after a terrorist attack compared with their aggregate exposure. They would

[51] The federal government is assumed to recoup the portion of insured loss it initially paid above insurers' payments up to an industry aggregate of $15 billion in 2005.

keep all their premiums and transfer the loss to all commercial policyholders and taxpayers. This points to an inequity in this system, because the policyholders of those insurers who do not suffer any loss are responsible for the same amount of repayment to the government in the form of a surcharge as are policyholders in companies that suffered large losses and were subsidized by the government.

Rationale for Limiting Aggregate Exposure

There are several reasons why insurers may not be willing to assume the large aggregate exposure implied by an E^* gaming strategy. First, a larger E^* increases the likelihood that an insurer will experience medium to large losses below its TRIA (or TRIEA) deductible with the more structures insurers cover in high-risk areas. In this sense insurers may decide to limit their aggregate exposure by estimating the likelihoods of different terrorist attack scenarios occurring. Insurers may then reduce their aggregate exposure by utilizing their survival constraint in a manner similar to the processes they follow for other catastrophic risks. Second, when an insurer provides coverage against terrorism it also provides insurance against all other events that could cause damage or losses to their property and/or claims from their workers' compensation coverage. When an insurer decides whether to write more terrorism coverage, it needs to consider its aggregate exposure from a much broader set of risks (e.g., fire, theft, job injury).

Insurers may be concerned that Congress will amend a permanent TRIA-like program if legislators observe the type of strategizing described above. Suppose insurers who expanded their coverage by focusing on E^* were to be held responsible for 50 percent of their losses above their TRIA deductible. These insurers will very likely want to cancel some of their commercial policies for fear of incurring large claim costs after a terrorist attack. One reason why these insurers have not followed an E^* gaming strategy today is their concern that a TRIA-like program will not be renewed in its current form.

8. The Way Forward: A Perspective on Long-term Options for Terrorism Risk Financing

Although TRIA has provided an important and necessary temporary solution to the problem of providing terrorism insurance to commercial firms, we do **not** believe it or its successor TRIEA is an equitable and efficient program in the long run. We now turn to a set of alternative options that involve the private and public sectors for providing protection against terrorism losses on a more permanent basis. These alternatives are not mutually exclusive. Some combination of these and perhaps other options should be considered in the design of a program that provides protection against terrorism losses while at the same time encouraging risk-reducing measures by those who are potential targets for a future attack.

Deploy Capital of Potential Target Firms

Modern enterprise risk management has shown that it often makes sense for a firm to use its own capital to absorb risk, rather than insuring against a loss. In these

circumstances, the firm can manage the risk through its own capital management strategy. For example, the firm may lower its debt financing in relation to equity to be able to tolerate more risk. Other more focused strategies include the use of structured debt (e.g., warrants, convertible and forgivable debt) and more recently the use of contingent capital (i.e., financing that is contingent on the occurrence of specified events). Thus, we would envision that a large part of terrorism risk is, and will continue to be, absorbed by the firm's own capital, so that it is, in fact, self-insured.[52]

Those institutions providing long-term debt financing to developers could possibly underwrite potential losses from terrorism and charge higher interest rates to reflect the additional risk. Equity capital investors could hold more diversified portfolios, so no single investor would suffer a large and disproportionate diminution in the total value of assets in the event of an attack.

Deploy Capital of Reinsurers

One potential private market solution that has been discussed is to increase the transfer of risk through reinsurance (Congressional Budget Office, 2005).[53] Since reinsurance portfolios normally cover sizable losses in the tails of the distribution, reinsurers normally need to hold relatively large amounts of capital compared with primary insurers. During the past several years, most major reinsurers experienced reductions in capital, in part due to the 9/11 attacks, and several of them were downgraded by rating agencies. They decided not to allocate much of their scarce capital to terrorism risk, instead focusing their capital on other lines.

Results from the survey of reinsurers undertaken, as part of the Wharton Risk center *TRIA and Beyond*, by the Reinsurance Association of America indicate that the reinsurance industry's capacity for providing terrorism coverage under the TRIA program in 2005 was in the range of $5--6 billion. According to those surveyed, if a TRIA-like program were not in place, reinsurers would either maintain the same amount of reinsurance coverage or reduce the amount they provide.

More detailed analysis needs to take place as to the role that private reinsurance could play in providing protection against catastrophic losses from terrorism. One possibility would be a TRIA-like program without individual insurer deductibles that would only provide payments once losses exceeded a large aggregate threshold[54]. This approach would stimulate the demand for reinsurance and would avoid some of the

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[52] For more details on strategies that firms can use to self-insurance against risks see Doherty, N. (2000), *Integrated Risk Management*, New York: McGraw-Hill.
[53] Congressional Budget Office (2005), *Federal Terrorism Reinsurance: An Update*, Washington, DC, January.
[54] Notably, the leading reinsurance companies reentered several European markets for terrorism insurance after 9/11. Most of them did so because their exposure was limited and that they were all part of a pooled reinsurance tranche of a national program. See Michel-Kerjan, E. and Pedell, B. (2005), "Terrorism Risk Coverage in the Post- 9/11 Era: A Comparison of New Public-Private Partnerships in France, Germany and the U.S.," *The Geneva Papers on Risk and Insurance*, 30: 1, pp. 144-170. This article also discusses programs in Spain (established in 1954) and the United Kingdom (established in 1993; modified in 2003).

distortions associated with individual insurer deductibles and inclusion of captives in the program[55].

Another complementary option would be to base any federal reimbursement of terrorism losses on net (i.e., after reinsurance) losses without requiring reinsurers to make terrorism coverage available. Such a change might significantly increase the scope of reinsurance and associated risk spreading. The terms of reinsurance would reflect the federal backstop (i.e., the reinsurer's ability to be reimbursed for losses), thus reducing reinsurance prices. Primary insurers would be free to either buy reinsurance if available at the right price or keep similar exposures as under the current system.

Reduce Tax Costs for Insurers and Reinsurers to Hold Capital

U.S. federal tax policy increases the costs of private-sector arrangements for spreading catastrophe risk, thus reducing the supply of insurance and alternative risk-spreading vehicles. Insurers cannot establish tax deductible reserves for events that have not occurred. More importantly, providing insurance against rare but potentially enormous losses requires insurers to hold large amounts of equity capital, which is primarily invested in marketable securities. Investors can readily purchase the same types of securities directly or through investment funds, in which case the returns on the securities are subject to personal taxes only. When held by an insurer to back the sale of its policies, the returns are taxed twice -- at the corporate level and at the personal level -- because insurers cannot hold such capital in tax-deferred accounts. For the securities to be used to back policies, the premiums must therefore be high enough to compensate investors for the extra layer of taxes. The total cost can be very large for the amounts of capital that must be invested to back the sale of insurance for rare but potentially extreme events, such as large losses from terrorist attacks.

The private sector's capacity to offer coverage for losses from terrorism (and other extreme events) would therefore expand if insurers and reinsurers were allowed some form of tax-deferred reserves for terrorism coverage. Such a policy could reduce the costs to insurers and reinsurers of holding the large amounts of capital necessary to provide coverage. This should increase supply and reduce premium rates. A tax-deferred reserve approach should be weighed carefully in light of a number of potential benefits and possible drawbacks: a short-term reduction of tax revenues, the disadvantage of industry-specific tax rules, and the challenges of designing a system that meets the objectives of expanding capacity to insure losses from terrorism (and possibly other extreme events) without allowing significant unrelated tax deferral.

Facilitate the Use of Terrorism Catastrophe Bonds [56]

[55] End of 2004, nearly $35 billion in terrorism coverage capacity was provided by industry captives in the states of Vermont and Hawaii only (the two largest on-shore captive states in the U.S—700 and 150 licensed captives end of 2004, respectively). For a detailed discussion on captives in the context of terrorism insurance in the US, see Wharton Risk Center, Chapter 9 (2005).

A catastrophe bond transfers the risk of a large loss from the insurance/reinsurance industry to the financial markets. A significant market for catastrophe bonds to cover losses from terrorist attacks has not emerged since 9/11. To date, only three terrorism-related catastrophe bonds have been issued and these were part of multi-event coverage for other risks such as natural disasters and pandemics. For example, the first bond was issued in Europe in August 2003. The Fédération Internationale de Football Association (the world governing organization of association football [soccer]), which is organizing the 2006 World Cup in Germany, developed a $262 million bond to protect its investment. Under very specific conditions, the catastrophe bond covers losses resulting from both natural and terrorist extreme events that would result in the cancellation of the World Cup game without the possibility of it being re-scheduled to 2007.[57]

The lack of interest in new financial instruments for covering terrorism risk may be due to concern by investment managers that potentially a large loss from a catastrophe bond would hurt their reputations (and possibly their compensation). Another reason why there has been no market for terrorism catastrophe bonds might be evident in the reluctance of reinsurers to provide protection against this risk following the 9/11 terrorist attacks. Financial investors perceive reinsurers as experts in this market. Upon learning that the reinsurance industry required high premiums to provide protection against terrorism, investors were only willing to provide funds to cover losses from terrorism if they received a sufficiently high interest rate.[58]

Most investors and rating agencies consider terrorism models as too new and untested to be used in conjunction with a catastrophe bond covering terrorism risks. The models are viewed as providing useful information on the potential severity of the attacks but not on their frequency. Without the acceptance of these models by major rating agencies, the development of a large market for terrorism catastrophe bonds is unlikely[59]. In addition, institutional, tax and regulatory constraints have discouraged the growth of terrorism-related and other catastrophe bonds.

A study should be undertaken to analyze behavioral, institutional and regulatory obstacles to the development of a more robust market for terrorism catastrophe bonds, as well as the steps that would need to be taken to modify the current situation.

Mutual Insurance Pools

Another alternative would be to allow insurers to form an insurance pool to deal with specific lines of coverage, perhaps with some federal backing for large losses. In effect, a group of companies would provide reinsurance to each other. For example, firms insuring high-risk assets in the United States and around the world could form their own

[56] This section is based on Kunreuther, H. and Michel-Kerjan, E. (2005) "Insuring Mega-Terrorism: Challenges and Perspectives". Report for the OECD Task Force on Terrorism Insurance. In OECD: *Terrorism Insurance in OECD Countries*, July 5.
[57] Congressional Budget Office (2005), *Federal Terrorism Reinsurance: An Update*, Washington, DC, January. Kunreuther and Michel-Kerjan (2005), "Insurability of mega-Terrorism: Challenges and Perspectives", in OECD (2005); ibid.
[58] Kunreuther, H. (2002) "The Role of Insurance in Managing Extreme Events: Implications for Terrorism Co[illegible]rage", *Risk Analysis*, 22: 427-37.
[59] [illegible] S. General Accounting Office (GAO) (2003), *Catastrophe Insurance Risks. Status of Efforts to Securitize Natural Catastrophe and Terrorism Risk*. GAO-03-1033. Washington, D.C.: September 24.

mutual insurance pools. This solution has the advantage of spreading the risk over a large number of insurers who join these pools, but it is unclear whether this alternative would provide adequate coverage against mega-terrorism. Pool solutions developed in several other countries should be analyzed in more detail to determine their potential application to the U.S. market[60]. The pool does not have to provide coverage for the entire country, but can be focused in certain types of risks and/or industries.

Publicly Administered Mutual Insurance

The need for federal protection against terrorism risks and those of other extreme events comes from the combination of two defects. The loss probability is highly uncertain and the maximum possible loss is considered to be large relative to the amount of private reinsurance and catastrophe bonds available to insurers. One strategy for addressing these two problems is to construct a type of publicly administered mutual insurance arrangement.

Two key conditions must hold for this arrangement to be feasible. First, although losses on individual properties can be highly correlated and aggregate damages can be large, the losses cannot be perfectly correlated. For example, the arrangement could absorb a severe attack on Houston, New York, or San Francisco, but not necessarily if the three cities were attacked simultaneously. Second, buyers need not agree on what they think the loss probability is in each site, but they must be able to agree (in the simplest case) that it is the same, or (in a more complex case) on what the relative likelihoods are. For example, all buyers might agree that a large-scale assault is twice as likely in Houston and New York as in San Francisco.

The insurance would work as follows for the case of a mutual insurance program protecting insurers providing terrorism coverage in these three cities. Each insurer would choose a level of protection through the mutual pool and pay an estimated premium. If no attack occurs on either site after a predefined period of time, any excess premiums above a certain threshold are returned to these insurers in proportion to their original purchase. Suppose a loss does occur in Houston, for example, and if its magnitude is less than resources accumulated by the pool to that point, all claims are paid. But if total insured losses exceed claims, insurance buyers are assessed an additional amount to cover claims. In this example, New York and San Francisco policyholders furnish the capital to cover excess claims in Houston. In effect, this arrangement uses as its source of excess capital the undamaged assets of pool participants who have not suffered a loss. Such an arrangement might be voluntary, but it might be made compulsory as well, with the *ex post* assessments proportional to the additional coverage that was made mandatory.

Federal Reinsurance with Explicit Premiums

Another possible response to the limited capacity of private insurers and reinsurers to furnish coverage against catastrophic losses is a federal reinsurance program with explicit premiums. The most obvious technique for pricing federal reinsurance would be for the government to calculate a premium. It would make its own estimate of the probability of a major attack and the extent of the damages, calculate the expected

[60] See OECD (2005), Terrorism Risk Insurance in OECD Countries, July 5.

value of the loss, add a modest amount for administrative expenses, possibly tack on a "risk premium", and offer unlimited amounts of coverage for sale at this premium.

Under a federal reinsurance program, in years without any major terrorist attack, no benefits would be paid out. But if an attack occurred, these government's collected funds would be used to cover the catastrophic portion of the losses against which insurers had purchased federal reinsurance. If the losses protected by federal reinsurance exceeded the premiums collected, the government would have to finance these claims from other sources of taxpayer revenue. Over time, if the premiums accurately reflected the risks of terrorist attacks, the government reinsurance fund would be replenished.

Considering Covering both Domestic and Foreign Terrorism[61]

Another question that needs to be addressed is whether the arbitrary distinction that the current U.S. terrorism risk insurance program makes between so-called "foreign" and "domestic" terrorism reflects the current nature of the terrorism threat[62]. This poses at least two major problems.

First, the evolution of international terrorist activities from more locally organized and even national groups to global organization makes it difficult to distinguish between a domestic and foreign terrorism, as illustrated by the July 2005 bombings in London, UK[63]. Some of these terrorists had been trained to kill in Pakistan. Should one thus conclude that they were "acting on behalf of a foreign person or foreign interest"? On the other hand, they had been living in London for years, studying or working there. Should one conclude they acted on behalf of their own ideology? In that case, should we conclude that the nearly 800 casualties were victims of domestic terrorism? Had these events been more devastating and occurred in the U.S., would they have qualified for TRIA coverage? Today this gray zone is likely to inflict legal costs to both victims and insurers, and considerably delay claims payments to victims of the attacks.

Second, the decision to exclude domestic terrorism from TRIA and its extension because it was not considered a serious threat needs to be reevaluated in the light of the current threats posed by extremist groups in the United States[64]. Data on domestic

[61] We appreciated discussions on this domestic terrorism issue with James O. Ellis III (Memorial Institute for the Prevention of Terrorism in Oklahoma City), Mark Potok (Southern Poverty Law Center) and with Henry Schuster (CNN).

[62] TRIA stipulates that a terrorist attack would be certified as an act of terrorism only if it is perpetrated by "an individual or individuals acting on behalf of any foreign person or foreign interest, as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion."

[63] For an insightful analysis of the London bombing in that regard, see the series of articles in The Economist (2005), "In Europe's midst", July 16.

[64] For discussions on the nature of these groups and their operation, see Ellis III, J. "Terrorism in the Homeland: A Brief Historical Survey of Violent Extremism in the United States", Memorial Institute for the Prevention of Terrorism, Oklahoma City; Hoffman, B. (1998) *Inside Terrorism*. New York: Columbia University Press; Stern, J.. (2003). *Terror in the Name of God: Why Religious Militants Kill*. New York: Harper Collins. Potok, M. (2004). "The American Radical Right: The 1990s and Beyond." in Eatwell, R. and Mudde, C. (eds) *Western Democracies and the New Extreme Right Challenge*, Routledge; Frey, B. (2004) *Dealing with Terrorism: Stick or Carrot*, Edward Elgar Publishing; Chalk, P. Hoffman, Reville, R and B. Kasupski, A-B. (2005) *Trends in Terrorism*, Santa Monica, CA: Rand Corporation, June.

terrorism from the U.S. Federal Bureau of Investigation reveal that over 350 acts of domestic terrorism have been perpetrated on the U.S. soil during the period 1980-2001. Although the annual number of such attacks decreased during the 1980s and mid 1990s, it started increasing again in the past ten years averaging 15 attacks a year nationwide during the period 1996-2001[65]. It is likely that this increase has been galvanized by anti-globalization imperatives[66].

Consideration should therefore be given as to whether it is desirable to include domestic terrorism as part of the events covered in a national terrorism insurance program. The analysis should consider whether the economic rationale for government involvement in covering the risk of large losses from domestic terrorism is any different from foreign terrorism, as well as the problems associated with the arbitrary distinction made by TRIA between "foreign" and "domestic" acts.

Developing Incentive Programs for Encouraging Mitigation

Moreover, further analysis is needed to link mitigation and insurance coverage in a more systematic way. It would be important to develop incentive programs to adequately reward private sector investment in security, for example by lowering the price of terrorism risk financing and/or by providing any other economic incentives (e.g., more favorable tax treatment). It is worth noting, however, that the absence of a link between insurance and investment in security is not specific to the United State[67] -- most industrialized countries have not yet implemented such incentive programs either.

9. Conclusions

Today, four and a half years after 9/11, the question as to who should pay for the economic consequences of a terrorist attack on the United States has not yet received the attention it deserves. As stated by the White House in its 2002 National Strategy, homeland security is "the concerted effort to prevent attacks, reduce America's vulnerability to terrorism, and minimize the damage and recover from attacks that do occur"[68]. To succeed, security must be a comprehensive national effort.

The new law extending TRIA for two additional years directs the President's Working Group on Financial Markets to study long-term availability and affordability of coverage for terrorism losses. This group must submit a report of its findings to the House Financial Services and Senate Banking Committees by September 30, 2006. As we have already advocated[69], Congress or the White House should consider establishing a broader national commission on terrorism risk coverage before permanent legislation is

[65] U.S. Department of Justice, Federal Bureau of Investigation (2002), "Terrorism 2000/2001", FBI, Counterterrorism division, Publication 0328.
[67] Auerswald, P., Branscomb, L., LaPorte, T., and Michel-Kerjan, E. (eds) *Seeds of Disaster, Roots of Response. How Private Action Can Reduce Public Vulnerability*, Cambridge University Press, forthcoming.
[68] The White House (2002), *National Strategy for Homeland Security*. Washington, DC., July.
[69] See Kunreuther, H. and Michel-Kerjan, E. (2005), "Terrorism Insurance 2005. Where Do We Go from Here?" *Regulation. The Cato Review for Business and Government*, Washington, DC: The Cato Institute, Spring 2005 pp. 44-51. See also The Economist (2005), "In Europe's midst", July 16 and The Economist (2005), "Horrible Business: Terror Insurance", November 19.

enacted. Indeed, the challenges associated with terrorism risk financing are fundamental, and they will not be solved overnight. In addition to the insurance industry, there is a need to include representation on such a National Commission from sectors of the economy who are affected by the terrorism risk such energy, transportation, real estate and health. U.S. Treasury representation should be supplemented by key individuals from federal agencies, such as the Department of Homeland Security and the Department of Defense who are concerned with national security issues.

Such a National Commission could explore the objectives of a terrorism risk financing program and how to achieve them through alternative risk sharing mechanisms. In addressing these issues there is a need for collaboration with the homeland security/intelligence community to measure what potential threats are. A National Commission could also examine how other countries cope with the terrorism risk to determine whether these approaches merit consideration for the United States. The insurance infrastructure would undoubtedly play a key role in such a program, but it should be viewed as part of a broader strategy for dealing with terrorism. For example, the public and private sectors could provide economic incentives in the form of lower taxes, subsidies or lower insurance premiums to encourage those at risk to adopt higher security and loss reduction measures. There will likely be a need for well-enforced regulations and standards to complement these incentive programs.

The design of a terrorism insurance program reflects society's view as to who should pay for the losses from the next attack[70]. Hurricane Katrina is likely to impact on how citizens, firms and policymakers envision the role and responsibility of the public and private sectors in providing adequate protection to victims of large-scale disasters and the importance of understanding how actions taken before a disaster impacts on the need for financial assistance after a catastrophic event occurs[71]. Similar questions need to be posed with respect to the terrorism risk. A well-designed terrorism insurance program has the potential of encouraging mitigation measures while at the same time alleviating the need for large-scale public sector involvement following the next attack.

[70] Indeed, other countries have implemented programs quite different from TRIA; see Michel-Kerjan, E. and Pedell, B. (2005), "Terrorism Risk Coverage in the Post- 9/11 Era: A Comparison of New Public-Private Partnerships in France, Germany and the U.S.," *The Geneva Papers on Risk and Insurance*, 30: 1, pp. 144-170. See also Organization for Economic Cooperation and Development (2005), *Terrorism Insurance in OECD Countries*. Paris: OECD, July 5. For a comparison of terrorism insurance prices and take-up rates per different industry sector in the US and different European countries, see Michel-Kerjan, E. and Pedell, B. (2006), "How Does the Corporate World Cope with Mega-Terrorism? Puzzling Evidence from Terrorism Insurance Markets" *Journal of Applied Corporate Finance*, Vol. 18 (4), December 2006.

[71] Daniels, R., Kettl, D. and Kunreuther, H. (eds) (2006), *On Risk and Disaster: Lessons from Hurricane Katrina*. University of Pennsylvania Press.

APPENDIX 1
Deductible over Surplus Ratios: 2003 to 2005 and Prospective Analyses 2006-2007

Using data provided by A.M. Best, we undertook an analysis of the top 463 companies[72] ranked by their 2004 TRIA lines direct earned premiums (larger than $10 million). For each insurer, we had the following data:

- Total direct earned premiums all lines;
- Total direct earned premiums (DEP) for TRIA lines;
- Surplus (*S*).

We determined the deductible over surplus (*D/S*) ratio for the three years of TRIA operation: 2003, 2004 and 2005. Table A provides the data for determining the *D/S* ratio for 2005 when D = 15 percent and it also shows these ratios for 2004 and 2003 when D = 10 and 7 percent, respectively, for the top 30 insurers (ranked by total TRIA DEP in 2004). Note that in 2003 only three insurers in the top 30 had a ratio *D/S* ratios equal to or higher than 15 percent, while this number increased to 14 insurers in 2005.

Prospective Analysis: Impact of TRIA Extended to 2007 on *D/S* ratios

Below we show how the extension of TRIA would impact on the *D/S* ratio for the top 30 insurers in the U.S. for 2006 and 2007. The new deductible is increased to 17.5 percent of TRIA-line DEP in 2006, and 20 percent in 2007.

Methodology The study is undertaken for the top 30 insurers. In order to determine *D/S* (2006) and *D/S* (2007) for each company under these two scenarios, we need to know what would be their TRIA-lines DEP and their surpluses in 2005 and 2006, respectively. We base our analysis on the annual percentage change in these two numbers over the three-year period (2002-2004) for each of the thirty companies. We then extrapolate these figures to estimate DEP for TRIA lines and surpluses (*S*) for 2005 and 2006. Table A presents the result of this analysis. With the deductible increased to 20 percent in 2007, 6 of the 10 largest insurers will have a *D/S* ratio that will be 20 percent or greater.

[72] The original sample of insurers with a 2004 total TRIA-line direct earned premium above $10 million was made of 466 insurers; but partial data were missing for 3 of them. As discussed, among these 463 insurers, our 2004 selected sample is made of the 451 insurers that also appear in the 2002 and 2003 data sets.

Table A. 2003-2007: Prospective *Analysis* D/S Ratios for the 30 Largest Insurers, 2003-2007
D=17.5% DEP in 2006 and 20% DEP in 2007 (all amounts in $ million)

Name	Projected 2006 TRIA Line DEP	Projected 2006 surplus	Projected. Deductible 07	D/S 2007 (20%)	D/S 2006 (17.5%)	D/S 2005 (15%)	D/S 2004 (10%)	D/S 2003 (7%)
AIG	32,663	110,524*	6,533	6%	5%	4%	3%	2%
St. Paul Travelers	20,069	16,907	4,014	24%	21%	17%	12%	8%
Zurich/Farmers	18,170	13,647	3,634	27%	25%	23%	18%	13%
Liberty Mutual	13,101	13,307	2,620	20%	18%	16%	12%	9%
CA State Comp Ins Fund	9,024	3,156	1,805	57%	50%	43%	37%	27%
CNA Insurance	9,024	7,436	1,805	24%	21%	17%	13%	8%
Chubb	9,365	13,608	1,873	14%	14%	14%	11%	9%
Hartford Insurance	9,901	18,006	1,980	11%	10%	10%	7%	5%
ACE INA	7,766	3,963	1,553	39%	37%	33%	22%	18%
Nationwide	5,376	12,159	1,075	9%	8%	7%	4%	3%
TOP 10:								
- Total	134,459	212,713	26,892	Mean ratio	Mean ratio	Mean ratio	Mean ratio	Mean ratio
- Average	13,446	21,271	2,689	23%	21%	18%	14%	7%
State Farm	4,898	68,565	980	1%	1%	1%	1%	1%
Allianz of America	3,524	4,626	701	15%	15%	15%	10%	9%
W. R. Berkley	5,510	4,639	1,102	24%	22%	20%	14%	11%
Great American P&C	3,592	3,109	715	23%	21%	20%	13%	10%
FM Global	3,006	6,500	601	9%	10%	11%	10%	8%
XL America	3,560	2,824	712	25%	23%	20%	14%	10%
Cincinnati Insurance	2,600	7,622	520	7%	8%	8%	8%	6%
Berkshire Hathaway	2,941	84,182	588	1%	1%	1%	0%	0%
Auto-Owners	3,032	4,346	606	14%	11%	9%	6%	4%
Safeco	2,560	4,699	512	11%	10%	9%	7%	5%
Progressive Insurance	3,059	6,508	611	9%	8%	6%	3%	2%
Old Republic General	2,501	2,215	500	23%	19%	15%	10%	6%
HDI U.S. Group	1,957	561	391	70%	57%	46%	33%	19%
Allstate Insurance	1,942	20,531	388	2%	2%	1%	1%	1%
Fairfax Financial (USA)	1,299	4,832	260	5%	6%	7%	5%	6%
Markel Corporation	1,990	1,967	398	20%	19%	18%	13%	10%
Arch Capital Group U.S.	3,323	663	665	100%	66%	42%	23%	3%
GE Global	1,478	8,467	296	3%	3%	3%	2%	2%
White Mountains	996	3,181	199	6%	6%	7%	4%	4%
Erie Insurance Group	1,724	3,967	345	9%	7%	6%	4%	3%
TOP 30								
- Total	189,951	456,717	37,982	Mean (average) ratios				
- Average	6,332	15,224	1,266	20%	18%	15%	11%	6%

* This represents shareholders' equity rather than policyholders' surplus that se… …ore appropriate here.

APPENDIX 2
Brief side by side comparison between TRIA 2005 and TRIEA 2006-2007

	TRIA	Extension of TRIA (TRIEA / S. 467)	
	2005	2006	2007
Program trigger (« per event » in 06-07)	$5 million	$50 million	$100 million
Insurer's deductible (% DEP previous year)	15%	17.5%	20%
Federal share (% above insurers' deductible)	90%	90%	85%
Industry aggregate retention/recoupment threshold	$15 billion	$25 billion	$27.5 billion
Annual Program Cap	$100 billion	$100 billion	$100 billion